A practitioner's perspective on current choices in respect of rules- or principles-based auditing standards

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Introduction

The Chairman of the International Auditing and Assurance Standards Board, John Kellas, recently asserted that the Board's Standards on Auditing "are principles-based, and [that the] recently proposed revisions place clear emphasis on the objectives of the auditor's work rather than the process of the audit" (Financial Times, 24/1/06). His comments were in response to an article by Stella Fearnley and Tony Hines which had questioned the introduction of common standards across the world, when the regulatory frameworks in which they are applied are fundamentally different. During the same week, Andrew Whittaker, the Financial Services Authority's (FSA) Director responsible for better regulation, outlined his hopes for the FSA becoming a more principles-based regulator. His plans for the FSA's shift of emphasis are based on an existing set of eleven high level principles, which include 'a firm must conduct its business with integrity' and 'a firm must deal with its regulators in an open and co-operative way.' In contrast, the International Auditing and Assurance Standards Board (IAASB) does have International Standard on Auditing (ISA) 200, 'Objectives and General Principles Governing an Audit of Financial Statements' but this does not really provide a sound basis for principles-based standards, as it requires compliance with a code of ethics, compliance with ISAs, and due regard to the guidance of professional bodies, legislation and regulations. The ISA does not engage with the purpose of an audit. The two understandings of what actually is principles-based are radically different – one means boiling it down to a handful of high-level statements with supporting guidance whilst the other has a wide suite of mandatory requirements.

In this paper, I will explore a little further the varying definitions of principles-based and rules-based regulation, and consider the impact these have on the current debate about the development of auditing standards. However, before talking about auditing standards, I will outline my background and following from this some general qualities which my experience leads me to attach particular importance. I will then explore how auditing standards are used in practice and the manner in which they shape conduct and expectations, as those developing their structure and content should take this into account. I will then give a working definition of rules and principles, drawing on the concept of going concern to illustrate the lack of consensus which exists around what constitutes a principle. This definition provides a basis for considering the extent to which auditing standards in general have been in the past and are today, rules- or principle-based. Looking specifically at auditing standards on going concern, I will argue that the standards have gradually become increasingly detailed and prescriptive. Finally, I will suggest a few reasons for and implications of, this change.

Before I go any further, I would like to make it very clear that the entire content of this paper represents my own thoughts on the topic and does not represent the policies or the views of my employer Deloitte and Touche LLP. Similarly, whilst I am a member of the Audit Quality Forum's Working Party looking at rules- and principles-based auditing standards, the content of this paper does not represent the views of the group. For those interested in the ideas of the Working Party, we will be producing a paper in Summer.

I have indicated that my perspective is that of a practitioner because my academic training was not in the area of audit, and my thoughts on auditing are not based on academic research. Having spent three years' training with the small London accounting and audit firm Begbies Everett Chettle, I moved to the technical department of Deloitte, where I now work. Whilst I routinely participated in audit work at Begbies, conducting an audit is not currently part of my day job. My responsibilities include updating audit working programmes and my firm's guidance on reporting issues. I respond to questions from audit teams about how to apply a particular accounting or auditing standard or aspect of the firm's audit methodology. I also draft responses to formal consultations on auditing standards, accounting standards and company law. Rather than being an auditor, my role in the technical department could be characterised as that of a translator and interpreter of regulatory and accounting requirements to my client-facing colleagues who are working on audits. In this respect, I occupy an area between theory and practice, as I support practitioners in applying the requirements of standards in the specific context of their work.

As a result of my experience, I have developed a particular perspective on the audit. Explaining the detailed requirements across a wide range of topics has made me acutely aware of both the complexity and fast rate of regulatory change. My own preferences for style of auditing standards stem from the fact that auditors are generalists, rather than narrow specialists in auditing standards, and need to be able to understand audit standards readily. It follows that auditing standards should be straight-forward to understand and apply, and that complexity should be avoided wherever possible. In my opinion, these qualities will be easier to achieve if auditing standards are principles-based than if they are rules-based.

How are auditing standards used?

Before looking more closely at the nature of specific standards on audit and going concern, I thought it might be useful to share some ideas about the manner in which auditing standards are used by auditors in firms of differing sizes. First, although I sat down and read some auditing standards from start to finish for the purposes of writing this paper, this is not the typical approach an auditor. In the technical department, we will read an audit standard through from start to finish for the purposes of responding to consultations and identifying which of our procedures, and hence which of our working papers or guidance may need to be revised. In larger audit firms, working programmes are supported by extensive literature giving detailed guidance on firms' policies on how to conduct an audit. The technical department may also be approached directly for guidance. As a result of these alternative sources of guidance, the auditing standard itself may be consulted by the auditor at a later stage in their enquiry. In contrast, in a small firm, the auditing standards are more likely to be consulted as an earlier source of information. This is because working programmes are usually purchased from and updated by an external provider and printed firm policies and guidance are likely to be limited. This means that where the firm's programmes don't cover a particular issue, the auditing standards are likely to be the next source of guidance.

When auditing standards are consulted, in firms both small and large, it will usually be with a particular question or concern in mind. For example, guidance on how to word an audit report when a company is not a going concern may be sought. Auditing standards will not normally be read in their entirety. The manner in which standards are used should shape their content and development. For example, the fact that they are consulted to resolve particular queries means that specific requirements or guidance need to be capable of standing alone, and should make sense even if the whole standard has not been read. In addition, as they are normally approached after a firm's own working programmes – whether produced in-house or externally – they should not duplicate the level of detail which these provide.

Why are auditing standards important?

The manner in which auditing standards influence the conduct of auditors and others emerges from the ways in which they are used. Within firms, they inform the content of working papers, firms' policies and approaches. In so doing, standards structure the audit process, shaping both the work performed and the content of the audit report. Moreover, auditing standards promote common practices amongst different firms, as all auditors must follow the mandatory requirements and many will choose to follow guidance which is not compulsory. Whilst auditors do not apply auditing standards in a uniform manner, the identity of the profession is partly defined by auditing standards.

Whilst I have considered auditors as the users of auditing standards, they also provide an external reference point for assessing the conduct of the audit by regulators, the courts and other parties. For example, bodies such as the Professional Oversight Board for Accountancy could have regard to auditing standards, and compare a firm's actual conduct with that set out in the standard, to identify whether or not the firm has conducted a 'proper' audit. In this respect, auditing standards are themselves a method of increasing accountability, as they provide a set of criteria by which the auditors' work, via the auditors' working papers, can be assessed. The extent to which regulators should be defined as a key user, and whether auditing standards are or should be drafted to meet their specific needs, are questions outside the scope of this paper. I raise them here as I think they might usefully be considered as part of the wider discussion on the development of auditing standards.

Definition of rules and principles

As this paper is on rules and principles, a working definition of the terms will be useful. I will not venture to offer anything more definitive. As with many things, the longer I have thought about this topic, the less clear cut it appears. Defining them in relation to each other is straight forward, if not theoretically robust. Speaking as a practitioner and not in an academic capacity, I will not let such problems detain me.

I would expect a rule to contain a more detailed level of requirement than a principle, and to address a narrower issue than a principle. Due to the relatively more narrow scope of a rule, I would expect to be more likely to identify a document as rules-based if it had numerous requirements, than if it had few. And I would think a rule may be more likely to explains the means by which an objective is achieved than be the end towards which the auditor works.

These criteria seem straight-forward and it would appear to be easy to distinguish rules from principles. However, when I told Ian Dennis, a lecturer at Oxford Brookes, and fellow member of the Audit Quality Forum's working party, about my paper on going concern and auditing standards he asked me whether the going concern concept and its application to the preparation of financial statements is a rule or a principle? Let's explore their definitions by looking at the idea of going concern in auditing and accounting standards.

The going concern basis of accounting is described by ISA 570 as the "record[ing of] assets and liabilities on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business" (Paragraph 3; similar to SAS 130 -5). The amount at which an asset recorded, and whether a liability is classified as falling due after or within a year may be different where an entity is not a going concern. Deciding whether a company is a going concern or not involves making a forward-looking judgement, and involves an element of uncertainty. The decision to use the going concern basis is made by the directors and assessed by auditors.

As to whether this is a rule or principle, the International Standard on Auditing on going concern, ISA 570, is unambiguous. It states that "The going concern assumption is a fundamental principle in the preparation of financial statements" (paragraph 3). Likewise, the Companies Act 1985, Schedule 4, Part Two consists of sections on accounting principles and accounting rules. Along with consistency, prudence and the accruals basis, going concern is categorised as an accounting principle, and the law states that 'The company shall be presumed to be carrying on business as a going concern' (paragraph 10).

In contrast, accounting standards do not identify going concern as a principle. We will briefly consider United Kingdom Generally Accepted Accounting Practice (UK GAAP) and International Financial Financial Reporting Standards (IFRSs). First, we turn to UK GAAP in which Financial Reporting Standard (FRS) 18, Accounting Policies, ties the use of going concern concept to the statement of principles, without making going concern itself a principle. FRS 18 states that "The information provided by financial statements is usually most relevant if prepared on the hypothesis that the entity is to continue in operational existence for the foreseeable future" (paragraph 18). Relevance is one of the qualitative characteristics financial information ought to possess, according to the Statement of Principles for Financial Reporting. In the context of UK accounting standards, going concern is not a principle but a hypothesis which normally helps achieve the objective of relevance.

In IFRSs going concern is introduced in the Framework for the Preparation and Presentation of Financial Statements. The Framework describes two underlying assumptions – the accrual basis and going concern. These are introduced after the objective of financial statements and before their qualitative characteristics, but the going concern assumption is not explicitly linked to either.

In accounting standards, then, going concern does not appear to have quite achieved the exalted status of principle, although in the audit standards and company law it does. This shows that the language of rules and principles is not employed uniformly, even within a relatively narrow realm. Our consideration of going concern highlights a problem for the current debate about auditing standards: there is not a clear consensus about what constitutes a principle or rule. The language has largely been exported from discussions about accounting standards, and specifically from comparisons of US accounting standards which have been characterised as rules-based to those of other countries, including the UK, which have been described as principles-based. For example, in January 2002 the Financial Accounting Standards Board published a proposal on a 'principles-based approach to US standard setting' and the following year the Securities and Exchange Commission submitted a report on the adoption of a principles-based accounting system. Partly as a result of these terms having been applied in this aligned but not identical context, and also due to the wide everyday usage they have, the meaning of principles and rules is slippery and difficult to nail down precisely. There is scope for confusion and a requirement to be specific about what we mean.

Rules and principles in Auditing Standards in general

We will now move from discussing rules and principles in a general sense to looking specifically at auditing standards, and the extent to which they are rules- or principles-based. The first Auditing Standards issued by the Institutes of England and Wales, Scotland, Ireland and others in 1980 rejected a rules-based approach. The explanatory foreword stated:

"It would be impractical to establish a code of rules sufficiently elaborate to cater for all situations and circumstances which an auditor might encounter. Such a code could not provide for innovations in business and financial practice and might hinder necessary development and experiment in auditing, In the observance of Auditing Standards, therefore, the auditor must exercise his judgment…"

I have not found a similar rejection of rules in the latest version of the Auditing and Reporting handbook, suggesting a shift along the rules-to-principles spectrum may have occurred in the direction of more rules. This is also implied by the relative volume of guidance which audit standards today occupy in relation to those in the 1980s.

In the Financial Times last October Peter Wyman, PwC's Head of Professional Affairs and former president of the Institute of Chartered Accountants in England and Wales argued that standards appear to be moving further towards a rules-based approach, stating " Recent auditing standards have adopted a more US-style and approach than their predecessors and I believe we are at a vital point in the process to develop truly international standards. The direction we take will almost certainly establish the precedent for standards-setters for the foreseeable future.' Recent international standards which may be characterised as more rules-based include the 'risk ISAs' on 'The Auditor's Responsibility to Consider Fraud in an Audit of Financial Statements' (ISA 240), 'Obtaining an Understanding of the Entity and its Environment and Assessing the Risks of Material Misstatement' (ISA 315) and 'The Auditor's Procedures in Response to Assessed Risks' (ISA 330).

Rules and principles in going concern standards in particular

Moving from this somewhat anecdotal discussion of auditing standards in general to look more closely at those on going concern in particular, I would argue that a trend towards more rules can also be discerned. The auditing standards issued in 1980 did not include a standard which addressed going concern specifically. In 1985 Auditing Guideline 410, 'The auditor's consideration in respect of going concern' was published and gave brief guidance which explained indicators of going concern difficulties and provided example wording for reports. This was superceded in 1994 when the Auditing Practices Board's Statement of Auditing Standard (SAS) 130, the first standard aimed specifically at going concern. Constructed much like other SASs, SAS 130 included nine 'basic principles and essential procedures' indicated by bold type and interspersed with a much larger volume of explanatory guidance. Since then the Auditing Practices Board (APB) has adopted ISAs, which include ISA 570 on going concern. In adopting the ISAs, the APB has introduced new requirements – many of which are imported from the old SASs – and the resulting UK and Ireland ISAs will be referred to here. Rather than set out the content of the standards to you in detail, I will highlight a couple of areas of difference between the SAS and the ISAs, as this helps illustrate how auditing standards on going concern are changing and, indeed, the extent to which they have not.

In contrast to many aspects of the audit which are focussed on historic information, assessing whether a business is a going concern relates to the future. This forward-looking dimension introduces a greater degree of uncertainty, and means that judgements made at a point in time may be shown by subsequent events to have been inappropriate. This was acknowledged in Appendix Two of SAS 130, which provides illustrative example of audit procedures and auditors' reports in different situations, where the introductory paragraph observed that:

"As auditors would need to exercise judgement in the circumstances described it is possible that different auditors may arrive at different conclusions"

Whether stakeholders in the audit process, including regulators, feel comfortable with the idea that different auditors could occasionally reach different conclusions in identical circumstances is a moot point, but it is worth keeping in mind that the audit report offers an opinion rather than a definitive judgement. Many might prefer to think that the audit process offers more certainty, and may also regard more detailed standards as a way to achieve a greater level of consistency. Putting stakeholder views aside, ISA 570 does not include the illustrative examples and does not make the same reference to the possibility that the application of judgement may result in a range of outcomes. However, both the examples and explanatory paragraph remain in the 'UK and Ireland' specific section of ISA 570, suggesting that the 'ISA plus' is more principles-based than the ISA as issued by the IAASB.

A second area of change is that ISA 570 has more requirements, and more detailed requirements than SAS 130, suggesting a gradual move towards increasing level of prescription. Whereas the SAS had 9 requirements, ISA 570 has 18. More scepticism – or less trust – is required, for example paragraph 22 has a specific requirement for the auditor to ask management about events after the period of assessment which they have used to consider whether the company is a going concern or not. If management had deliberately used a shorter period of assessment to avoid factoring a particular future event into their thinking and conclusion – that is, an event which would make the going concern basis inappropriate - management would be compelled to reveal it to the auditor applying the ISA.

There is more detail on planning in the ISA (paragraphs 11 & 12) than in the SAS, and more explicit directions for auditors to reach a conclusion. Overall, the ISA, including the APB's 'ISA plus' version, is more prescriptive than the SAS it replaces. However, the changes are incremental rather than fundamental, and the approach of the ISA is, broadly speaking, similar to that of the SAS it replaces.

Reasons for, and implications of, different regulatory regimes

In my view, the increased level of prescription is related to a lack of trust in both management and auditors to do the right thing, a suspicion which relates at least in part to the major corporate and audit failures we have seen in the past few years. In the absence of trust, rules, with a reduced scope for interpretative flexibility, appear to offer a method of control. However, I would argue that they are incapable of delivering a permanent improvement to either regulation in general or audit quality in particular because dishonesty and poor judgement can contribute to failures in systems based on rules or principles.

One factor which is important in preventing the failure of regulatory regimes is enforceability. A regulatory system based on principles clearly needs to be enforceable if it is to be effective. Andrew Whittaker of the FSA talked about breaches of principle being enforceable providing the principle had predictive value, that is, if at the time someone could see that they were acting in a manner which breached a principle, it could be enforced. I would argue that the nature of what is being enforced in a principles-based system is subtly different. Whereas a rule can be breached, I suggest that the term 'breach' is inappropriate in the context of principles which do not cultivate a compliance culture. Failure to observe a principle is a more appropriate description of departures, and enforcement should penalise non-observance rather than breaches.

In conclusion, there appears to have been an incremental shift along the spectrum of principles to rules, in the direction of the latter. My own feeling as that a response to prescription is a focus on compliance with the detail of the requirement, which may or may not be in alignment with its spirit. However, a shift in the opposite direction would require more attention to defining the purpose of audit and articulating an assurance framework. A model system of principles-based regulation would comprise a framework for assurance in general (such as that developed by IFAC, the International Federation of Accountants), a definition of the purpose of the financial statements audit specifically, along with standards which would be at a sufficiently high level such that they did not duplicate the detail in firms' working papers. Shared values would be important to such a system. For example, the FSA's set of principles, to which I referred earlier, use language such as 'integrity' and 'open and co-operative', and a certain level of consensus around these terms needs to exist for requirements based on them to be enforceable. This consensus may be harder to achieve in an international context than in a specific cultural milieu. Similarly, defining the purpose of audits is no mean task, and will be harder to do at the international level than for particular regions. Regardless of personal preferences for the style and content of auditing standards, I reiterate that there is a requirement for more precision in the language we use. For example, it would be possible for all to agree that a principles-based system is a good thing, whilst implementing changes that move standards – in the eyes of some but not of others – in a different direction.

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