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Discussant's Response to The Role of Auditing Theory in Education and Practice

R. K. Mautz

Ernst & Ernst

Bob Hamilton and I approach the nature, purpose, and usefulness of auditing theory so differently that after reading his paper I thought it best to give him a call so we might get better acquainted. As I suspected, we had met earlier, but I still knew very little about Bob's background and experience. Interestingly enough, we have similar educational and experience histories. Both of us have commitments to and have spent considerable time in academic work; both of us have had practical audit experience. The major difference is that I have been at both of these for a considerably longer time than has Bob. To which one of us that is an advantage or disadvantage, you must decide.

Given those similar backgrounds, why is it that we should have such different interests, that we should approach auditing theory in such disparate ways? Our conversation suggested that Bob is not at all troubled by our differences. On the contrary, he expresses himself as thinking our differences may have usefulness, at least for the purposes of this symposium, in encouraging discussion. So let me note in more detail the nature of our major differences and then try to explain why I think they exist.

Different Approaches to Auditing Theory

Bob takes a broad view of auditing theory. He calls for a theory that explains the role of auditing in our economy, what it does, why the economy encourages it, what impact auditing has on the economy, why auditing exists at all, and the conditions of that existence. He writes:

. . . a theory of auditing should show why an economy will be better off if auditors can provide their services.

He is also greatly interested in the supply and demand for audits and notes:

Audit-like activities are a significant resource-consuming process of state verification which is assumed in most models of resource allocation mechanisms. An understanding of the nature of these activities is essential to understanding why one mechanism is preferred to another.

Thus he seems to be more concerned with the functioning of the economy, with how and why the economy allocates some part of its resources to auditing, and with what the economy receives in return, than with how auditors allocate their resources, spend their time, or face their problems.

Consistent with this, he recommends an approach to the study of auditing theory that uses the tools of economic analysis to explain how the economy allocates resources to auditing. At one point we find:

The essential characteristic of this approach is to rely heavily upon the tools of economic analysis to provide an explanation of this economic phenomenon—auditing activity.

And at another point:

What would be the details for the components of an auditing theory? A simple statement is that it would explain the demand for and the supply of auditors. Such a theory would permit an analysis of the effects on the supply of auditing of changing institutional arrangements, of expanding the subject matter of auditing, and of new technologies for producing audits.

Bob also calls for a theory that:

. . . should include a systematic consideration of the major elements in the practice of auditing: the institutional structure, the market for audited information, the characteristics of agents doing auditing, being audited, and using audited information, and consider the available auditing technology.

The Purpose of Auditing Theory

This is the scope of a theory of auditing in his terms, but what is its purpose? For Bob, a requirement of theory is that it provide a basis for testing hypotheses. Presumed theoretical writing that does not do so fails to earn the appellation of "theory." He expresses concern that existing auditing theory has not been directly beneficial for the theoretical support of tested hypotheses. Because those items he recognizes as early attempts at auditing theory formulation have not "spawned underpinnings for empirical research" he relegates them to a non-theory sort of limbo. He notes with approval, however, a trend, or at least a tendency, in more recent writings on auditing theory to emphasize "the requirements for testing and validation," but also that auditing theory will not be complete as long as it possesses "ambiguity which precludes testing" and until it can "facilitate comparison with competing and complementary theories so as to make validation possible."

This is an ambitious program. Bob is himself impressed, and desires us to be concerned, by the fact that we lack a complete theory of auditing. He will be satisfied with nothing less than a theory that fully explains the auditing activities of the world around us—everything from the justification of auditing as an economic phenomenon down to the level of why and how the amount of resources used to audit a public company may differ from those used to audit a private entity. The rewards and penalty system for auditors must fit into auditing theory as part of the explanation of why and what auditors do. All of this must be developed in such form that it lends itself to empirical verification and is both predictive and testable. The theory must be one that

. . . identifies the major determinants of the auditor's decision process and how they are affected by changes in the auditor's environment.

Bob visualizes a wide range of uses for auditing theory highly beneficial to education, practice, and research. But there are dangers as well. He points out the possibility that some interested parties might wish to advance the cause of those theories which would result in resources being allocated in their favor. He fears also that policy decisions will be made within accounting firms on the basis of theory that is not well grounded, verified, and tested, and he believes that the profession suffered in its testimony before recent Congressional hearings in not having "a well constructed and tested descriptive theory of concentration within the CPA industry."

A Different Approach

In contrast, my own approach to auditing theory, if I dare even to use that term, is at a different level. My interest is in the individual auditor, his responsibilities and obligations, in how he goes about acquiring sufficient evidential matter on which to formulate and defend, if necessary, his audit judgment. Bob Hamilton and I have significantly different notions of theory. His appears to be one that requires provision for the establishment and testing of hypotheses on some empirical basis, and without this testing he feels there is a question whether the term "theory" is warranted.

No doubt my views have been affected by my early training. I recall Professor Littleton describing theory quite simply as the reasoning that explains practice. Good practice is supported by good theory; bad practice is explained by bad theory. In Littleton's view, a constant interplay should exist between theory and practice so that each is tested against the other. Those theories that do not work well in practice should be reexamined. Those practices that lack logic or rational support likewise require reconsideration. Gradually, as each is tested against the other, both theory and practice are improved.

To the best of my knowledge, Professor Littleton never engaged in what is now termed empirical research, so he was not inhibited by requirements to support his conclusions with formulae and statistical interpretation. He had, however, spent a good deal of time in studying the rules of logic as well as in keeping abreast of current developments, and he urged that we be scientific in our development of theory, although he was quick to point out that accounting was not itself a science in any strict sense of that term.

Accepting Professor Littleton's notion that theory is the reasoning behind practice, my own interest in auditing theory has been directed toward what an auditor does, how he does it, and how he might do it better. Is this empirical? Well, certainly it is if empiricism is linked with experience as my dictionary says. My background and experience at both the staff auditor level and more recently at a somewhat more exalted rank provide an empirical foundation on which I rely heavily.

Professor Hamilton (you can tell the going is getting heavier by my use of his formal title) offers the gratuitous comment that:

. . . the theory of evidence has developed in isolation of the institutional arrangements which reward and penalize auditors, clients, and others.

He offers no proof or even an adequate explanation of that statement. Because he had at that point made reference in his paper to some totally academic discussions of audit evidential matter and of the relationship of such evidential matter to audit opinions, he may have meant to confine his comment to those papers. If he meant to include some of the earlier work on evidence, whether in *The Philosophy of Auditing* or elsewhere, he is quite in error. It would be an almost impossible task for a practicing auditor with any significant experience to write on the subject of evidential matter and at the same time ignore such institutional arrangements as the SEC, the courts, plaintiff bar, competitive fee structures, staff classifications, his own audit firm's organization, and the like. If, as the dictionary states, empiricism has to do with experience, practitioners are well equipped to test hypotheses.

An Empirical View of Theory

Professor Hamilton pronounces:

Once a description of the demand for and supply of auditing is forthcoming, individuals can decide whether to produce audits and whether to pay the price for audits.

Without the benefits of the extensive theory that he seeks, my own empirical observation is that a great many people and corporations have already decided that they are willing to pay the price for audits, and that thousands of auditors are eager to produce such audits. Without any visible concern for Professor Hamilton's desired theory, these people make just such decisions as he alludes to. How do they do it?

Those of us who now participate in such activities have a pretty good idea of how and why such decisions are made. To seek to develop and test hypotheses on such matters strikes us as less useful than would be the same amount of effort directed to a different set of questions.

As a "brief and terse (these are his words) explanation of how a theory of auditing may be developed" Professor Hamilton offers the following:

If there exists a government to enforce contracts, and due to differences in wealth endowments, *inter. alia.*, individual agents in an economy find it advantageous to put their wealth in the charge of others, then contracts which reward performance may be based on numbers recorded by the manager. If the owner of the wealth does not have a way to ensure the compliance of the reports with the contractual provisions or if the manager does not have a way to convince the owner of this, then certain contracts may not take place. If an auditor is incorporated into the arrangement to ascertain compliance and if the auditor is motivated to do so because of associated rewards and penalties, then valuable contracts could be formed and all will be better off.

What a marvelous grasp of the obvious! What does such glorification of that which is readily apparent really accomplish? Can't we accept the fact that in a market economy based on credit, auditors have a usefulness, and because

ours is a litigious environment they have every reason to be effective and efficient? Seeking overblown language to cloak the mundane is not likely to help either present or future auditors to serve more efficiently.

We need attention to practical issues that permit an auditor to survive and to serve effectively within an already institutionalized environment. Theorizing about those institutions and about the nature of that environment on such a high level is unlikely to provide much help to the auditor who must learn to respond and react to an SEC influenced by chief accountants as different as Andrew Barr and John Burton, to audit committees stimulated by increasing directors' responsibilities, and to governmental proposals for more control over audit activities. Broad scale theories of a global nature are unlikely to take into account personality differences which can be incredibly important in terms of cost and responsibility. Such theories exist at a level remote from the problems of the day, problems of litigation, of repropoals, of increased fee competition, and of personal performance under trying conditions.

I can see little benefit to the profession or to our economy, and certainly none in the immediate future, from the kind of theorizing that Professor Hamilton proposes.

In discussing the advantages of a theory of auditing for educational purposes, for example, Professor Hamilton writes:

A concern for time allocation to various coverages in an auditing course could be aided by a theory of auditing which identifies the major determinants of the auditor's decision process and how they are affected by changes in the environment. Those critical points of influence on audit decisions could be given sufficient time to assure that they are well understood, with the more sensitive variables studied in depth.

Now those are beautiful words, but for the life of me I don't know what they mean or how to apply them in developing an auditing course. My major concern as an auditing teacher is with helping students behave on the job in such a way that they can analyze the audit risk, identify the representations in the financial statements, gather and evaluate relevant evidential matter, reach a defensible judgment on the validity of the financial statement representations, and, during all of this, have a working awareness of their responsibilities as professional auditors.

I would much rather give them an understanding of audit evidence, the extent to which it can be relied on, the dangers in relying on less than the best evidence, and the cost of obtaining various types of evidence, than to have them theorize about how changes in the environment affect major determinants of the auditor's decision process.

Note where Professor Hamilton's approach is intended to lead us. He states:

The purpose of this paper is to describe the nature of a theory of auditing which would improve the underpinnings for explanations of audit activities and to identify specific linkages between improvements in theory and difficult problems in auditing education and practice. A theory of auditing can help improve our understanding of the role for auditing in society and thus improve the ability of society's members

to design institutional structures and to take action which leads to desired outcomes.

Auditing is a term associated with activities having specified characteristics. An auditing theory should describe those activities and their particular configurations and intensities.

A Vote for Pragmatism

If we carry on with that paragraph and with subsequent statements, we find that Bob has a view of the theory of auditing so comprehensive in scope that it far escapes my imagination. Indeed, I know of no activity of man for which a "complete, compact, and consistent story" exists in the scope and extent of detail which he proposes for auditing. Nor does Professor Hamilton propose such a theory. He just thinks that one could and should be developed. And in the last pages of his paper, with commendable caution, he offers some reasons why he could not have been expected to provide one.

So where does all this leave us? The difference between Bob and me and the way in which we define, think about, and propose auditing theory reflects a classic contrast of approaches. The macro approach which he prefers is at best a long-term possibility for progress. The micro approach that I choose offers immediate possibilities for improvement in auditing education and practice. My goal for auditing theory lies in the near term improvement of the profession, of education for it, and of its research efforts. I feel a strong need for improvement that will give us candidates better qualified to practice auditing in today's environment, to strengthen the profession's service to the economy now.

I have not even a casual interest in putting the profession under a microscope for intellectual examination to discover what motivates whom or why, and how various interests respond to various stimuli. I am only remotely interested in that great day in the future when Professor Hamilton's global theory may finally be tested and found complete.

One of the reasons I find myself so much concerned about our differences is that the increasing gap between education and the practice of accounting and auditing, whether in industry, the CPA profession, or government, bodes ill for the future of both. More and more I find that the interest that academics have in accounting and auditing theory and practice has little relevance to the practitioner's problems. We have few forums to bring practitioners and academics together, and when we do, the results typically are something of a Mexican standoff.

In two paragraphs near the end of his discourse—paragraphs which I must confess are not completely clear to me—Bob places his bet on the development of the kind of theory he has described in his paper. He concludes:

Actions taken by CPA firms, auditors, congressional committees, regulatory agencies and others can also be viewed as falling within a betting framework wherein the individuals who take the actions are placing their individual welfare on the line.

Practicing auditors put their welfare on the line every day in ways that few full-time academics are able to appreciate. Most practitioners would wel-

come help in reducing the odds they face. I find it disappointing that capable members of the academic community make their bets in such a way that any possible payoff is so far in the future as to be discountable to near zero in terms of today's needs.