Auditing as Independent Authentication

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With a Foreword by
R. J. CHAMBERS

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To Gaylene, Timothy and Simon
FOREWORD TO SERIES

During the 1960s and 1970s a remarkable series of books were produced by academic staff in the field of accounting at the University of Sydney. All were out of print. The Accounting Foundation believed that they should be made available to a new generation of scholars and researchers.

First and foremost amongst these was Accounting, Evaluation and Economic Behavior (AEEB), written by the University’s foundation professor of accounting, R.J. Chambers and first published in 1966. Several distinguished scholars have acknowledged that AEEB was a pivotal contribution to the development of the ‘decision usefulness’ theme in accounting research. It presented a systematic argument for the clarification of the meaning of key accounting concepts (such as ‘asset’, ‘liability’, ‘equity’, ‘revenue’ and ‘expense’). It argued that there was a need to identify the property of assets and liabilities to be measured in accounting—with Chambers proposing the use of current market prices, or contemporary cash equivalents. It also argued for the use of adjustments to the application of money as a measurement scale when there were changes in the purchasing power of money. Decades later, many (though not all) of these ideas were adopted by the international accounting profession, when profession-sponsored bodies published ‘statements of accounting concepts’ or statements of conceptual ‘frameworks’.

Chambers was a prolific contributor to research journals and many of those journal contributions are now available in electronic form. Amongst his later contributions in book form was Securities and Obscurities. When first published Chambers freely acknowledged that it was a polemic. Readers are left in no doubt that the world would be a better place if there was widespread adoption of ‘continuously contemporary accounting’. Suffice it to observe that during the 1960s, questioning of the ‘historical cost’ model of accounting was often regarded as a form of heresy. By 2006, a surprising proportion of accounting standards now prescribe the use of market values in asset or liability valuation.
But arguably Chambers’ greatest legacy at the University of Sydney was his encouragement of scholarly endeavour by colleagues and students.

The other books re-published at this time were all initially based on research undertaken by academic staff during the 1970s and early 1980s. The topics reflect the diversity of interests of the ‘Sydney school’ at that time: Clarke (1980) on the history of price level accounting, Walker (1978) on the history of ideas about the preparation of consolidated statements, Wells (1978) on accounting for common costs, and Wolnizer (1987) on auditing as independent authentication.

It was a period when academic research was largely analytical rather than empirically-based; and when the interests of academics at Sydney were largely directed at questioning the status quo—whether that be expressed in the way accounting or auditing was practised, or in the conventional wisdom as expressed in text-books of the time.

The interests of accounting academics have changed over time. But this collection of works displays the heritage of the University of Sydney in scholarly research and advocacy of the ‘decision usefulness’ theme in accounting.

(Neil Wykes)
President, Accounting Foundation
University of Sydney
FOREWORD

In all practical pursuits it is wiser to proceed with knowledge than merely with hope; and safer to proceed from reliable knowledge than from untested assertions, whatever their source. These beliefs underlie the calling of witnesses and the presentation of evidence in the dispensation of justice. They warrant the repetition of observations and experiments in the course of scientific inquiry. They are the reasons why, in the practice of diverse technical arts and professions, so much care is taken in getting at pertinent facts, and in authenticating what are represented to be the facts.

The same beliefs impelled the legislative fathers of the limited liability corporation to stipulate that companies shall report periodically on their financial positions and results, and that the contents of those reports shall be authenticated by auditors. Investors and others were intended to have reliable knowledge; they were not to be misled or misdirected. However, the intention failed of fulfilment. Almost from the outset, and ever since, litigated cases, official inquiries and idiosyncratic accounting practices have revealed the unreliability of many of the valuations and amounts appearing in the financial statements of companies. Relying on the unreliable has cost countless investors and creditors dearly. Auditors themselves have not escaped the consequences—substantial awards in damages at the suit of misinformed plaintiffs. Laws and regulations designed to reduce the exposure of auditors to bias and coercion have evidently been powerless to secure the publication of authentic dated information. The anomalous conflict between intention and outcome is the problem Dr Wolnizer’s book explores.

There is universal experience of, and an extensive literature on, the regulation of performance by recourse to authenticated information. It spans the domains of product standardization and process control, medical and surgical procedures, navigation, business management—and of instrumentation, metrology and scientific inquiry generally. Wolnizer’s delving in these directions converges on the conclusion that the principles of commercial auditing cannot differ from the principles of disciplined observation and discovery in every other domain. This is a powerful
conclusion. It would lift auditing from the ranks of the arcane arts to the rigorous safeguard it is expected to be.

Eminent accountants have averred that accounts should be true, realistic and reliable, a sentiment that Wolnizer endorses wholeheartedly. But from that point the book departs in material respects from traditional expositions of auditing. Traditionalists do not question the functional fitness of conventionally audited financial statements as guidance for judgement and choice; they have no cause, therefore, to regard auditing as a form of quality control. Wolnizer, on the other hand, makes the quality of information a recurrent theme. The traditional view tolerates modes of verification as diverse as careful observation and mere assent to the calculations or valuations of the officers of clients. Wolnizer, by contrast, holds that one mode of verification alone provides a test of the authenticity of all items that occur in financial statements; and indeed that only the products of observation can be so authenticated. The traditionalist regards the so-called independence of mind and independence of economic and kinship influence as sufficient guarantee of the reliability of the outcome of an audit. Wolnizer, on the other hand, identifies a third and crucial factor—recourse to sources of evidence that are beyond the influence of officers of the audited firm.

The work is novel in design and wide in ambit. Its conclusions may seem bold. But they are not overreaching, for they entail the same respect for reliable knowledge that, in other applied arts and sciences, has yielded rich harvests of functionally fit artefacts of every kind. The conduct of business and financial affairs has been less well served, and will continue to be so while uncorroborable fictions and outdated facts masquerade as authentic elements of statements of dated financial positions and results. Dr Wolnizer’s conclusions point in the direction of resolving many of the difficulties and dilemmas in auditing that have hitherto seemed intractable.

It is a privileged pleasure to commend the book to the attention of all who are concerned with the informed direction and oversight of business and financial affairs.

R. J. Chambers
Auditors of independent mind and status are widely believed to secure the reliability of periodical financial statements. Independence in those senses has been declared to be the ‘cornerstone’ of auditing theory, and the *raison d’être* and *sine qua non* of auditing practice. However, the connection between the independence of auditors and the reliability of the products of their labours has not been demonstrated; and from time to time those products have turned out to be utterly unreliable. These things provided the stimulus for the inquiry which culminated in this work.

Auditing in the modern style arose from the legislation enabling companies incorporated by registration to invite public subscription for their security issues. Investors were to be informed periodically of the states of affairs of companies by audited financial statements. Given reliable information they could take whatever steps they might think fit to protect or advance their interests. The directors of companies were to see to the preparation of financial reports: auditors were to authenticate the contents of reports. Company directors and officers, being more familiar with company affairs than auditors could possibly be, could influence the opinions formed by auditors. To avert that kind of influence, it came to be held that auditors should be free of non-trivial commercial dealings with clients and their officers and free of family ties with those officers. Those freedoms were to be the guarantors of the reliability of financial accounts. They came to be the substance of what is meant by independent auditing. However, such impartiality has little, if anything, to do with the quality of information. Auditors could diligently trace all the elements of financial statements back to their sources—in transactions and judgements—without concern for the impact of conventional accounting rules on the truth of what was subsequently reported in dated statements of financial position and performance. That is the road down which the traditional notion of independence led. What auditors claimed, with increasing frequency, was a duty of testing the details in accounts for conformity with data processing rules, not for consistency with commercial reality.
The present work began, then, with a survey of the views of professional accountants and auditors as they were expressed in the periodical and textbook literature of the past century. The notion of independence was construed throughout as having reference to the elimination of sources of external influence and bias. In the last forty years public accounting firms began to undertake ‘management service’ engagements for audit clients; fee earning action in the former role seemed to threaten independence in the latter role. But by that time, the focus of audit attention had become the conformity of the practices of client officers with the directions of management on the one hand and with conventional accounting principles on the other. The idea of authenticating the contents of periodical accounts by recourse to independent evidence had, with the exception of cash, receivables and payables, been submerged. In the face of evident shortcomings of prevalent practices, the debate had shifted to ways of shoring up the existent arrangements; for example, by appointment of auditors by public authorities, by audit committees and so on. But these could be no remedies, for they had no clear association with the quality of the information on which auditors must at last express their opinion.

Since the quality of the audited accounts was the source of commercial concern and the cause of much inquiry and litigation, I turned to other fields in search of patterns of ideas and arrangements that might confront directly the question of quality of information. The literatures of other fields, especially that of quality and reliability engineering, provided rich and penetrating insights into the problems associated with the design, specification and authentication of the functional fitness for use of manufactured products; and, by analogy, of financial statements. This work is, in essence, the product of a set of complementary ideas drawn from a variety of fields: ‘fitness for use’ from engineering; ‘objective use value’ from economics; ‘reliable knowledge’ from philosophy; ‘empirical testing’ from science; ‘measurement’ from metrology; and ‘evidence’ from the law. The association of these ideas yields the notion of auditing as a form of quality control which the text expounds. The key to this style of auditing is testing by recourse to independent evidence. Auditing, as independent authentication, is common to everyday experience, and is an essential activity when the dependability of things is imperative.
This work has benefited greatly from, and complements the ground-breaking contributions of Chambers and Sterling. It endorses wholeheartedly Chambers’s prescriptions for continuously contemporary accounting. Those prescriptions are the logical derivative of a rich and disciplined theory of the association between financial information and financial action. They yield financial statements whose elements have contemporary empirical referents in markets. To be a fit basis for making informed financial choices and judgements, the components of accounts must relate, and be relatable, to the environment of financial action, to contemporary markets. This argument has also been a recurrent theme in Sterling’s writings. In his case, however, it is an irresistible conclusion of a cogent demonstration of the application of measurement theory to accounting. That traditional accountants have had little regard for the question of the function to be served by accounts, and for the nature of measurement, may explain, at least in part, why extant accounting rules are unstructured and undisciplined. It may also explain, in part, why the lack of contemporary empirical content in conventionally prepared accounts has bothered so few.

To have had Professor R. J. Chambers, of the University of Sydney, as a mentor was indeed a privilege. His scholarship inspired me to join in the endeavours to elucidate ideas. At all times I found his keen insight to be challenging, and his incisive criticism to be constructive. His supervision of, and interest in, the writing of this work as a doctoral thesis encouraged me to persevere. The thoughtful suggestions, constant encouragement and practical support afforded by Professor M. C. Wells, Arthur Young Professor of Accounting in the University of Sydney, were most helpful. I thank Professor R. R. Sterling, Kendall D. Garff Distinguished Professor of Business Enterprise in the University of Utah, who, after the completion of this work, afforded me the luxury of time to read further, discuss and commence work on extending some of the ideas developed herein. I thank Professor T. A. Lee of the University of Edinburgh who also read and commented on the manuscript. I gratefully acknowledge my debt to these, and the many other scholars from whose work I gained much benefit. All, however, are absolved from whatever errors remain; whether of omission or commission. Acknowledgement is due to
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*P. W. Wolnizer*
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<td>AICPA</td>
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