

Auditing Reimagined

Navigating
Stakeholder
Expectations



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Emerald Publishing Limited
Emerald Publishing, Floor 5, Northspring, 21-23 Wellington Street,
Leeds LS1 4DL.

First edition 2025

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British Library Cataloguing in Publication Data

A catalogue record for this book is available from the British Library

ISBN: 978-1-83708-667-2 (Print)
ISBN: 978-1-83708-664-1 (Online)
ISBN: 978-1-83708-666-5 (Epub)



INVESTOR IN PEOPLE

To auditors who dare reimagining their profession

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Critics of the auditors are right in two respects: that the industry matters, and that it needs reform. It is in everyone's interest that auditing works.

The Economist. (2018a)

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PREFACE

Yusuf M. Sidani

Early in my professional career, I knew an experienced auditor, whom I'll call Ryan, who was still working well beyond his retirement age. Charismatic, eloquent, and impressive, Ryan often shared stories about his experiences as an auditor. As an inexperienced young auditor, I found his stories to be more insightful and inspiring than any "fundamentals of auditing course" could offer. Stories inform and inspire, and his certainly did.

One of the many stories I heard from him, more than once, was about a difficult judicial investigation he faced while auditing a failing company in an Asian country. The investigator questioned him about an alleged fraud, inquiring why the auditor "could not uncover the fraud before it happened and why he waited till it happened before reporting it." To fully grasp the seriousness of the discussion, one had to listen attentively to Ryan, as he always conveyed it with a hint of sarcasm. "When he asked me this question, I responded by asking why the police do not uncover crimes before they happen." Things went downhill from there, and it was only by luck that Ryan was not detained on the spot.

To be fair to the investigator, one might interpret his question as asking why the auditor didn't institute precautionary measures or monitor the internal controls needed to prevent the fraud. However, Ryan could clearly see that the entire case stemmed from misunderstandings and unmet expectations, as well as misinterpretations about the real role of an auditor. Is an auditor a gatekeeper, a watchdog, a police officer, an insurer against fraud, a compliance enforcer, or some type of co-manager?

Upon hearing more about the case, one would understand the irony. The auditor had been formally appointed only a few weeks earlier and had visited the company just once. Ryan noted, “They were still decorating the offices, and I couldn’t detect any business activity happening at the time.” His team had not started their audit procedures, except for the typical requests for documentation, trial balances, and other information in preparation for the fieldwork. The auditor had not issued any report or communication and was not expected to do so for some time.

Yet, the auditor found himself and his firm in the middle of a judicial investigation and facing the threat of disciplinary action. It took many more months of investigations and judicial work, along with a different understanding of the auditor’s role and responsibility by another investigator within the judicial system, for Ryan and his firm to be acquitted.

It was not only a matter of misunderstanding what Ryan did or did not do at the time. In the grand scheme of things, this was also about unmet expectations. We expect the auditor to alert us to fraud or potential fraud, to include a large enough sample in their work to uncover errors and irregularities, and to protect us as shareholders, potential investors, or other users of the financial statements. While these expectations are often reasonable, there are cases where they are not.

These latter cases might include instances where an auditor diligently performed their duties, assigning their best personnel to the audit, properly planning the audit process, and allocating the necessary time and resources for its execution. Despite this, there is no guarantee that every error will be uncovered or that nothing will go wrong. After all, an audit opinion provides “reasonable” assurance, not absolute or complete assurance. This level of assurance is often not sufficient for someone who has lost their investments due to reliance on the audit report.

The audit profession has been struggling with a persistent issue where what people expect from auditors does not match what auditors actually deliver, thus creating a gap in expectations that does not seem to go away. Despite significant advancements in accounting and auditing standards, educational approaches, auditor

training, and technology, this gap persists. This ongoing issue has been harming the profession. Every year, millions of flawless audits are carried out, but it only takes a few hundred cases around the globe – or even less – to tarnish a profession that has long prided itself on its professionalism and prestigious social status.

The reasons for this gap, as explained in this book, are myriad. Some reasons pertain to unreasonable societal expectations, ignorance about the real role of auditors, deficient standards, and even unfair media attention that often puts auditors in a negative light. Yet, in many cases of corporate failure, the reason might be more germane to the profession itself. Sometimes, the problems relate to a profession that has failed to evolve or be responsive enough, leaving itself in a state of inertia.

We address some of these issues in this book, reflecting on the history and performance of a profession that is in dire need of transformation. Our hope is that the profession can reinvent itself and reimagine its role to reaffirm its vital role in the functioning of societies and economies around the world.

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THE EVOLUTION AND CHALLENGES OF THE AUDITING PROFESSION

To win back the public trust, audit faces the challenge of re-envisaging its service through its primary purpose

(Buddery et al., 2014)

On New Year's Eve in 2018, a federal judge in Alabama found that one of the Big Four accounting firms had failed to uncover a long-standing fraud, citing this as professional negligence: "the case has sent shockwaves through a profession that has long sought to limit its responsibility for detecting malfeasance" (Masters, 2018). Despite industry lawyers expressing their anger over the ruling, the case concluded with a \$335 million settlement between the Federal Deposit Insurance Corporation (FDIC) as Receiver for Colonial Bank and the auditing company, down from the \$625 million initially ordered by the court (FDIC, 2019).

Holding an external auditor liable for not uncovering fraud is a common occurrence. To many in the auditing profession, this ruling was outrageous, failing to consider the auditor's role and the limitations clearly expressed in audit reports. Conversely, some observers contend that we should hold auditors accountable for their failure to detect major fraud schemes. Many users of financial statements rely on auditors for their decisions, making it unacceptable for auditors to fail in their expected duties.

Such incidents highlight an expectations gap where audit practitioners and other users disagree on the role of auditors. Several corporate fiascos over the years, linked to audit failures, have not helped the auditors' case. The auditing profession faces several challenges, including a persistent disparity between auditors and other stakeholders regarding their expected duties. These challenges also include an increase in corporate failures partially attributed to auditors, purported conflicts of interest, the impossibility of audit independence (Bazerman et al., 1997), and challenges brought about by digital transformation. Additionally, challenges arise in the education of future auditors, which have a significant impact on higher education institutions. This has led to multiple calls for audit and accounting reforms and initiatives at professional, regulatory, and educational levels to address these issues. In this book, we reflect on these challenges and how they operate in different contexts and regulatory frameworks.

The audit expectations gap is a significant and persistent challenge for the audit profession. This gap is now “worse than ever,” noted an accountant with 40 years of experience in a letter to the *Financial Times* (Akther & Xu, 2020; Kingsley, 2018). Many stakeholders accuse auditors of failing to meet expectations, which leads to decline in trust in the auditing profession (Oliver, 2018) and increased perceptions that auditors are not performing their jobs properly, resulting in accusations of professional negligence (Coram & Wang, 2021). Audit committees, board members, investors, creditors, regulatory authorities, and others have become increasingly demanding of auditors (PTI, 2018). This has resulted in calls to redefine auditor roles (Mackie, 2018), hence transforming the auditing profession itself (Kelly, 2018). This is particularly important given the ongoing evolution of the accounting and auditing professions, driven by newer standards, technological advancements, and many other factors, which have in many cases compounded the expectations gap (Holtzman, 2004).

Multiple studies have confirmed the existence of a gap. The Cohen Commission of Auditors, as early as 1978, sought to determine “whether a gap may exist between what the public expects or needs and what auditors can and should reasonably expect to accomplish” (Cohen Commission, 1978, p. xi). The Commission

identified an expectations gap and urged audit professionals and other parties involved in the preparation and presentation of financial statements to work together to bridge it. Despite repeated attempts by the auditing profession to close the gap, it has persisted. This has led to calls to examine this phenomenon, investigate its implications, its drivers, and how the profession should address it (Izza, 2019).

This book evaluates various understandings of the expectations gap, with a focus on the role of the auditing profession. Earlier reviews (e.g., Ali et al., 2015; Chye Koh & Woo, 1998; Omodero & Okafor, 2020) have not focused on the role of the audit profession and how institutional forces influencing the profession contribute to the persistence of the expectations gap. Understanding these factors can help identify what impedes substantial change. We argue that the auditing profession suffers from institutional inertia, which dilutes genuine industry restructuring to confront the audit expectations gap. We stress the importance of institutional entrepreneurs in breaking down this inertia and argue that the audit profession needs to play a significant and proactive role in addressing it, as it is best positioned to do so. We conclude by emphasizing the need for an innovative mindset in the auditing profession, necessitating a reimagining of the profession's role and a reconstruction of the auditor's identity.

Before exploring these issues, we provide a brief overview of the evolution of the audit industry. The profession today is vastly different from its past; the perception of a professional auditor now is not the same as it was many decades ago. Understanding the profession's history and transformations is crucial for envisioning its future path and opportunities.

AUDITING HISTORY

The word "audit" originates from the Latin word "*audire*," which means "to hear." This reflects the practice of early auditors, who would listen to verbal clarifications and explanations about the state of accounts from managers. Various sources indicate that forms of accounting and auditing existed in Ancient Egypt, Ancient Greece, the Roman Empire, and the nascent Muslim empire (Meuwissen, 2014).

Auditing is considered one of the “most ancient of all professions. Early civilizations apparently learned to audit almost as soon as they learned to write” (Smolinski et al., 1992, p. 7). Early tablets show writings by inspectors counting agricultural products. Other discoveries indicate that a form of auditing existed in ancient Mesopotamia, Egypt, Greece, and Rome. In ancient Athens, a basic form of audit included a system of accountability for public funds (Lane, 2023; Woolf, 1912), and public officials were subject to record examinations by government auditors (Atkinson & Jones, 2014, p. 329).

A culture of accounting flourished during the Roman era (LaGroue, 2014), with auditing functions aimed at preventing potential fraud by quaestors. Quaestors were individuals tasked with supervising the state treasury, and auditing was part of their roles (Kesimli et al., 2019). After leaving office, they were required to submit their accounts for examination by the newly appointed quaestors and also by the Roman Senate (Smolinski et al., 1992).

Some scholars note that a form of auditing over public finances existed in the early Islamic era. One of the pillars of Islam, *Zakat*, involved the collection of alms for the benefit of special categories of the poor, needy, and other authorized expenditures. This process required developing a function for collecting and disbursing these funds, along with monitoring and accountability mechanisms. Omar Ibn El Khat-tab, the second Caliph, established an administrative unit known as the *dewan*. The *dewan*, literally translating to “office” or “bureau,” managed and monitored the state budget and oversaw public expenditures. One of these bureaus, the Bureau of *Beit-ul-Mal* (treasury), was responsible for monitoring collections and expenditures.

Associated with the development of these bureaus was the institution of *hisbah*, or “accountability.” Guided by the Islamic principle of promoting good and forbidding evil in the marketplace, this historical institution involved appointing a *muhtasib*. This role loosely corresponded to an early form of auditing and market monitoring, ensuring that merchants followed proper practices in their transactions (Dogarawa, 2013; Rasyid, 2013; Talar, 2012; Zakiyah et al., 2019).

Although the *muhtasib*'s role was broad and included non-financial aspects, the economic aspect was significant in ensuring legal and ethical practices. The role included fraud prevention and oversight of pricing mechanisms. Some responsibilities encompassed the

broader notion of operational audit, such as ensuring product quality and inspecting production and merchandise. The *muhtasib*'s role is similar to an auditor's in another respect: reporting any wrongdoing in market practices to the authorities (Attahiru et al., 2016), which is akin to contemporary auditors reporting issues to relevant stakeholders in their audit reports.

Medieval Auditing Practices

Medieval times saw the emergence of more formal states, necessitating the development of an accountability system for the collection of taxes owed to the ruling classes. This necessitated the development of record-keeping and accountability systems. In medieval England, particularly under Henry I (1069-1135) and Henry II (1133-1189), an effective and strong state emerged, reinforced by a relatively efficient financial system (Jones, 2008). This period saw the need for financial controls, leading to the emergence of an early model of auditing. This was triggered to ensure accountability regarding state revenues and the financial affairs of various entities linked to the state, including religious institutions (Jones, 2008). One example of an audit mechanism that emerged was the exchequer audit, introduced by Henry I and further developed by Henry II, to manage the collection of royal revenue from the English shires. The system involved the adoption of written records and an audit. Understandably, this audit was primitive compared to the modern professional role, neither comprehensive nor methodical (Jones, 2009).

Woolf (1912) reports that in the 13th century, Leonardo Fibonacci, a well-known writer in Italy, was tasked with auditing the accounts of a certain commune. As trade networks evolved, ruling elites found more ways to accumulate wealth (Smieliauskas et al., 2020). With the growth of state powers and wealth accumulation came the need for accounting systems to measure revenues and wealth, and accountability systems to monitor the accuracy of record-keeping and limit fraud.

Two key milestones advanced accountability tools: the development of Arabic numerals and the double-entry bookkeeping system.

These developments improved the tracking of various accounts, culminating in the double-entry accounting system by Pacioli in 1494 (Smieliauskas et al., 2020, pp. 9–10). Pacioli's bookkeeping method spread across Europe, facilitating record keeping and profit determination. This greatly advanced the formation of accounting science and the gradual development of financial and cost accounting methodologies for better-informed decision-making. With better accounting methodologies came the need for improved accountability and auditing mechanisms.

By the 17th century, the notion of a "professional auditor," a role occupied by a trained person, was established (Woolf, 1912). LaGroue (2014) explained how early audit practices emerged in England and Scotland during the 16th and 17th centuries, focusing on validating and verifying the accuracy of accounting records. Auditors were tasked with ensuring the correctness of account entries, as highlighted in the 1564 English Book of Ordinances. Due to the expansion of bankruptcy laws in the late 17th century, auditors increasingly addressed legal requirements. This trend intensified in the late 18th century, particularly after the loss of the American colonies, when many entities and individuals faced significant financial losses or bankruptcies. The role of an auditor evolved, reflecting the increasing complexity of business operations, legal frameworks, and the onset of the Industrial Revolution (LaGroue, 2014).

Growth of the Profession

At the dawn of the industrial revolution, businesses began to grow, and their operations and structures became more complex. This increased the need for a better understanding of accounting and the accuracy of accounting records, triggering a demand for more formalized and standardized auditing processes and a professional auditing field. As businesses started to include outside investors who did not participate in daily operations, the need to provide an accurate picture and protect their interests grew in parallel. The profession transformed from a simple record-keeping system into one essential for advancing accountability and fraud detection (AbdulGaniyy, 2013).

The modern auditing profession emerged in Britain during the first half of the 19th century, driven by the growth of industrial activities and regulatory requirements. In 1831, a bankruptcy act provided the first “public recognition” of accountants as skilled professionals capable of conducting audits (ICAEW, n.d.). The UK Companies Act of 1844 mandated that directors of public companies maintain records and have their accounts verified by independent auditors, marking an early formal use of fair presentation. This legislation built on longstanding practices, and by the mid-1800s, early accounting firms that represent the precursors of the modern profession were established: Samuel Lowell Price (1849), William Deloitte (1845), William Cooper (1854), and William Barclay Peat (1870) (Meuwissen, 2014). The American Association of Public Accountants was founded in 1887, and it represented the first collective effort to garner national support and recognition in the USA (King & Case, 2016). In 1917, it became the American Institute of Accountants, later changing to its current name, the American Institute of Certified Public Accountants (AICPA), in 1957.

Around the 1850s, in Scotland, accountants operated within the legal profession, establishing a collaborative relationship with lawyers. During this time, the accountancy profession continued to grow. However, it became clear that the existing auditing system lacked methodological rigor, effective audit procedures, and professional independence. There was a growing realization of the importance of an independent auditing function:

In 1860, John Hollingshead complained about the inadequate, if not incompetent, auditing practices of joint-stock companies. Only when company managers and shareholders are compelled to ‘call in professional accountants and resort to an independent investigation’ will real auditing become a necessary part of a business organization, and the longer it is neglected, the more costly it becomes (quoted in Schmitt et al., 2002).

During the Victorian era, auditors sought to verify each transaction (AbdulGaniyy, 2013), a practice that later evolved into a sampling approach. The Victorian age saw the emergence of new professions alongside traditional ones like lawyers and medical

doctors, including engineers and accountants (Lee, 2011). Professionals began to organize into associations, signaling increased professionalization across these sectors. This era witnessed a shift from pre-capitalist values, such as a sense of “calling” and duty to community, to a market-oriented approach (Larson, 1977; Lee, 2011). The establishment of the Institute of Chartered Accountants in England and Wales (ICAEW) in 1880 was a critical juncture in the development of accounting. This occurred through the merger of five existing accounting organizations in response to growing industrial developments and business complexity.

By the end of the 19th century, professional auditors increasingly conducted financial statement audits. British firms established offices in the USA, driven by British businesses starting operations there. This significantly contributed to the development of the American accounting and auditing professions, with the first U.S. national accounting firm founded in 1883. The Certified Public Accountant (CPA) designation began in New York in 1896 and later spread to other states (Smieliauskas et al., 2020). The designation of “chartered accountant” was introduced in Scotland in 1854, followed by England and Wales in 1880. In the USA, the New York Stock Exchange mandated periodic financial reporting around 1899 (Smieliauskas et al., 2020), enhancing the relevance of professional auditing services.

The auditing profession established its identity during this era. At that time, there was no universally accepted framework for professional auditors and no general acceptance of the boundaries of their roles and responsibilities. The judiciary’s role in interpreting auditors’ obligations and duties further complicated this matter, leading to several legal cases reflecting early signs of an expectations gap. The Kingston Cotton Mill decision was ultimately recognized as a milestone, bringing some stability and confidence to the profession by defining, more clearly, auditors’ roles and responsibilities. While these and later rulings did not entirely remedy the expectations gap, as it remains relevant today, it was during this era that modern auditing practices began to take shape with a better clarity of auditors’ roles and responsibilities (Teo & Cobbin, 2005).

In 1879, based on a Companies Act in Great Britain, all banks were required to have audited accounts. In 1882, the ICAEW held its