

Quality Audit is never a matter of accident but the result of honest and sincere efforts, experience and the environment. The article throws a new light on the approach to the concept of Audit Quality and the tried and tested ways to achieve it today's fiercely competitive world of business.



It's time for a re-look at Audit Quality approach

Audit is a task involving judgement and decision-making. But arriving at a judgement is just a starting point that culminates into a communication either as a report or a presentation. It is essentially a team effort based on information processed and decisions made by each member of the team, ultimately presented by the team leader. Judgement and decision making abilities are attributes which develop over a period of time and therefore the foremost aspect which pushes up the quality of audit is experience. Experience should not be mistaken for years one has put in but to the exposure one has



*P.S.
Narasimhan*



*Anil Kumar
Khicha*

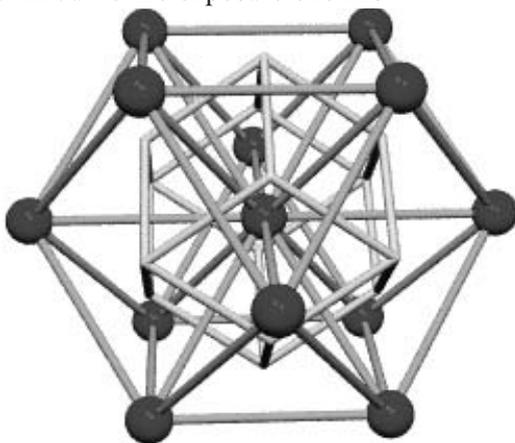
had over the years, the issues confronted, the literature one has gone through etc.

An aspect that should be kept in mind is that the auditors are constrained by the task environment they are in. Depending upon the degree of uncertainty that prevails in the task environment some measure of adhoc adaptation becomes necessary. A US expert named Watson studied the behaviour of the auditors and concluded that the more uncertain an environment, the less structured is the audit programme because in the face of uncertainty, one is forced to specify objectives rather than procedures. Thus,

auditors react to their task environment and by their own behaviour alter them. It becomes clear that Audit structure, time and peer pressure have an enormous impact on the judgement and decision making process. Ultimately, environment defines the context of such audit behaviour.

Resources on hand and constraints faced determine the audit quality. In a situation where the auditor has familiarity and expertise, his approach becomes almost automatic and with experience he is able to perform with diminishing effort.

When we say that audit is a task necessitating judgement and decision making, one can see this process running through all aspects of an audit. Even while facing a basic premise like 'going concern', the process of judgement and decision-making comes in. When one talks of the going concern concept, question arises as to whether what is referred to is about the company or its core business. Some years back the audit report of a listed corporate carried the views of its audi-

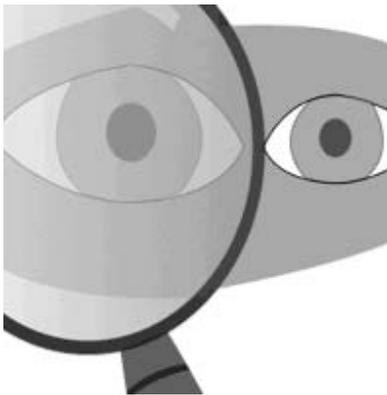


(The authors are members of the Institute. They can be reached at jas@satyam.net.in and khicha@eth.net respectively).

tors that it was not a going concern. This conclusion was arrived at on the basis of operating losses, negative cash flows etc., that corporate did a bit of reengineering later and is now functioning fairly well.

Does it make the conclusions arrived at by the auditors then, to be incorrect? Certainly not, it only goes to enunciate a basic axiom that **audit conclusions are mostly short term based. Similar are cases under Accounting Standard 22 - Accounting for taxes on income, where many corporates, which were reporting losses, cited the absence of reasonable certainty of realization for recognizing a deferred tax asset. The basis for such conclusion is again short term based.**

Accounting and auditing standards, guidance notes issued by ICAI all help the auditors in arriv-



ing at their conclusions.

Indianising Sarbanes Oxley was also to help the auditors to adopt an ethical approach and to ensure quality control and independence among the audit firms. The decision not to allow auditors to carry on non-audit services like accounting or extend appraisal/valuation services was also to keep possible bias away from the judgement and decision-making abilities. Rotation of auditors and the system of peer review, on the other

hand, are more confidence building measures vis-à-vis the users.

One basic foundation on which audit quality rests is the auditor's assessment of the internal control system that exists in a corporate. Committee of Sponsoring Organizations Integrated Framework for Internal Controls, called COSO in short, goes about defining what the internal control process is. As per COSO, internal control is a process to ensure that reasonable assurance is provided in achieving

- (i) efficiency and effectiveness of operations;
- (ii) reliability of financial reporting and
- (iii) compliance with applicable laws and regulations, COSO feels that external auditors are the most appropriate persons to help an organization achieve its control objectives by their recommendations for corrective action.

COSO has identified five independent variables such as control environment, risk assessment, control activities, information and communication and monitoring, as those, which would determine the effectiveness of the system of controls. Effectiveness of these five independent variables gets reflected in the operations, financial reporting and in compliance with laws and regulations.

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In short, the process of audit depends largely on the assessment of the internal control system that exists in a corporate. Right assessment enables the auditor to structure his approach to audit in a way, taking into consideration the aspects he has noted and such an approach determines the ultimate audit quality.

Now we come to analyse the role of audit plan, audit programme, training of audit staff etc. These help the auditors to arrive at an informed judgement. When a few years back a furore arose because an audit firm had destroyed its working papers, focus got shifted from the main issue. The problem was not the absence of the working papers but the fact that an investigation as to whether the auditors arrived at an informed judgement could not be completed.

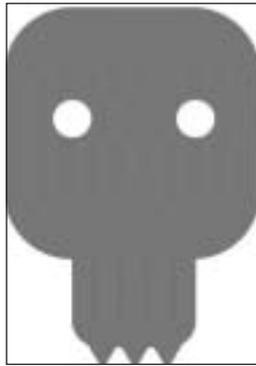
While there is some truth in the complaint that a structured approach does not allow the auditors to think outside the box, the lack of it, one should appreciate, is a lot more worse.

With Technology becoming the driving force, it is becoming

increasingly difficult to assess even a basic concept such as 'going concern'. Patents, know-how, brands, software, unique processes etc generate most of a Company's growth and shareholders' value.

Baruch Lev of United States points out that the return on investments in physical assets approximately equals the cost of Capital for most Companies. 'Investment in plant merely keeps you in the game' he adds. He goes on to say that the 'soft side' needs auditing as much as the 'hard side'. The extra focus on physical assets he derides saying that "if physicians reported the result of their examination according to generally accepted accounting principles, fat would be an asset!"

According to him, there is an urgent need to develop information that can reliably reflect the unique aspects of intangibles. He points out that U.S. Corporates alone spend a trillion dollars on Research and Development and yet the disclosures are perfunctory. Of late, basic research has provided more value additions to corporates. He suggests that disclosures on basic research, product development and process improvement may be made, for a start. In the case of software, expenditure on development and on acquisition, on employee training, on revenue earned from new products, on revenue earned from patent licensing fees etc., may be disclosed so that at least by comparison between periods and between the corporates the users of the financial statements may make appropriate judgements. The profession needs to encourage the corporates to



attempt them. Information on intangibles from the angle of productivity and asset values becomes vital and audit needs to focus on them.

We give below what in our opinion would lead to quality in audit. They are by no means exhaustive but remember, experience is a great teacher and that can tell us a lot.

What is Quality in Audit?

The audit which:

- i. provides a reasonable assurance to the concerned regulatory authorities,

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- ii. leads to better legal & regulatory compliances,
- iii. leads to improved systems & procedures for the business as a whole & particularly for the subject matter of the audit,
- iv. acts as a guide to successors,
- v. helps in better presentation of information &
- vi. provides reasonable professional satisfaction to the auditor.

HOW TO ACHIEVE QUALITY

1. Achievement of the basic minimum:

- i. The basic requirement as per the law under which the audit is conducted must be satisfied.
- ii. The positive / negative assertions as required under the relevant laws should be verified.
- iii. Compliance with ICAI's pronouncements is confirmed.
- iv. Timely completion of Audit is ensured.

2. Beyond the basic requirements:

The auditor has to

- i. study the business processes, internal checks & controls & accounting system for their effectiveness,
- ii. present a separate report to the management about the deficiencies observed & suggest potential improvements in functioning, systems, controls, records etc.,
- iii. appraise about the difficulties faced during the performance of attest function to the management and the suggestive measures.
- iv. suggest better presentation of financial statements / information. Transparency in disclosures to the extent possible be encouraged.
- v. inform the auditee the developments taking place in the field to his business and laws / regulations applicable to his business, so that the same may be duly used / complied with throughout the period.
- vi. furnish a trend Analysis & Ratio Analysis of major finan-

cial for last few years and its interpretation should be made available to the management as a separate report. Major drawbacks and achievements may be highlighted. Productivity and profitability ratios may be thoroughly analysed and reported.

3. Audit Approach

- ✎ Audit should be looked at by the auditor as a means to know in detail the business processes and not merely as a legal formality. It may be treated as an opportunity to make value addition to the auditee.
- ✎ Conduct audit nearer to the time of the transactions i.e., interim audit.
- ✎ Educate & train the auditees' staff about the purpose of audit & its potential benefits.
- ✎ Checklist need not be the ultimate but should be only a starting point. Innovative and Creative approach of Audit be encouraged. There must be a proper balance between professional independence, user's interest and statutory requirements.
- ✎ There must be a clear cut Scheme of - 'who will raise - queries to whom' during the audit, thereby avoiding duplication of discussions as well as to set a pattern - of queries from

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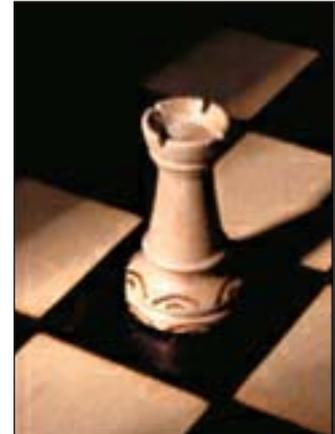
right person at the right time.

- ✎ More focus on systems & controls than on transactions should be the norm.
- ✎ Focus areas should be identified for detailed verification.
- ✎ The audit process should be system & manual driven rather than being Adhoc.
- ✎ Building a brand for the audit firm be kept in view.

4. Process of Audit

(A) Pre audit: audit planning

- ✎ Clear and unambiguous engagement letters be prepared and communicated with to the client - in case of non-statutory audits and first time assignments.
- ✎ Basic minimum procedures must be structured for each & every type of audit when undertaken first time and the same should be the base for future evolution and developments.
- ✎ A detailed questionnaire should be custom made for each client (suitably modified from a standard questionnaire) wherein all the basic details be collected from the auditee before hand and the same should be compared and replaced with the earlier questionnaire. Major changes must be noted as focal points for audit. All matters where management representation letter is sought should be covered under the questionnaire.
- ✎ Detailed Audit Program is a necessity. Checklist for



basic audit requirements, compliance of specific laws / rules / regulations / statutes etc., coverage of every negative and positive assertion / statement to be made in the Audit Report, compliance of ICAI's pronouncements regarding, Accounting, Auditing Standards & disclosures should all be part of the audit program.

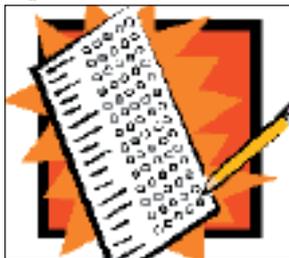
(B) During audit

- Gather details about nature of business, processes, activities, accounting methods / policies, organisational structure etc to be part of permanent file for being reviewed before every term audit
- Compliance with the audit program and deviations, if any should be justified.
- Focused to the objectives but not limit itself thereto, must be the motto.
- Every conclusion/qualification must be supported with appropriate Working Papers.
- Management Representation letter - covering all the positive & negative assertions made in the Report and items which are not possible to verify 100%, should be part & parcel of the audit evidence.

- Full scope for creativity / initiative through the exercise of audit should be system driven, must be given its play.
- Personal discussion with the management organised before the finalisation of the report
- Review of audit Working Papers by an independent equally competent person is a must - to see whether Working Papers guide to the conclusions drawn.

(C) Post audit

- ◆ Scope of Audit and limitations of Audit must be defined and disclosed.
- ◆ Personal discussion with the management should be organised on the report to the management.
- ◆ Checklist may be improved / altered after every audit & be made the base for next audit. New compliance requirements should be inserted based on the latest amendments.
- ◆ Rewarding the audit team based on the quality of audit & quality of documentation to motivate the audit staff to improve their performance.



(D) Audit Independence

- Independence of Audit In-charge and Audit team should be ensured at all times and periodic rotation of Audit In-charge must be encouraged.

(E) Audit documentation

- Documentation of the nature, timing and extent of audit procedures performed is the only

proof an auditor can produce to prove that the quality and quantity of work done were adequate for him to be able to reach his audit opinion.

- Documentation of conclusions drawn and, more importantly, the justification for his having reached those conclusions is essential for an auditor to be able to prove that he applied his mind judiciously and objectively to the situation under report and was not improperly influenced by the management in a manner that might be construed as having impaired his independence.
- Discussion on crucial issues / queries must be minuted and kept for record with a copy to the client.
- Over all Audit plan, detailed programme and check list should form the basic document
- Filing of papers should be such that they help easy retrieval.

(F) Staff training & development

- Interaction within the Audit team should be encouraged and the team must be directed properly towards the objectives of the audit.
- The Audit team may be made kept privy to all the discussions with the management, encouraging their active participation.
- Constant exposure to literature on the subject, CPE programmes etc., would add value to their work as well.

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at conclusions and look for evidences to support such opinions. This is really an invitation for disaster. Instead, auditors will have to approach the task with an open mind, peruse audit evidence gathered, and using their experience and expertise arrive at judgements and conclusions.

Auditors need to be focused on the task on hand, look for inter links between variables (eg; stock valuation) to evaluate performance and to evaluate assets. Moreover, auditors should peruse published accounts, for, a financial statement can teach more than any literature on the subject.

Technology is also likely to come a big way to the help of the profession. Already efforts are on to find out whether Artificial intelligence (Neural networks) can be used to study patterns in transactions, and the results are said to be encouraging. Use of such tools would indeed improve the audit quality in the years to come.

In short while an auditor should certainly value his time and efforts, after accepting an audit assignment discharging it to the best of his ability should be the attempt of a true professional. ■