

AUDITING – HISTORY AND PERSPECTIVES

Achim Sorin

*Univ. Babes-Bolyai Cluj-Napoca, Stiinte Economice Si Gestiunea Afacerilor,
Sorin.achim@econ.ubbcluj.ro*

Achim Monica

Univ. Babes-Bolyai Cluj-Napoca, Stiinte Economice Si Gestiunea Afacerilor,

Streza Raluca

student, Univ. Babes-Bolyai Cluj-Napoca, Stiinte Economice Si Gestiunea Afacerilor,

This paper refers to the audit process as to a very complex activity. There have been significant changes as the time passed by, changes that were necessary in order to keep up with the client's demands and the dynamic business environment. Despite the fact that there are certain stages to be followed while auditing, despite the standardized audit procedures, there however, remains the one element that adds value to the marketplace, and that is the auditor, as a human being. He bears the responsibility for the completeness, validity and accuracy of the financial statements. Therefore, he must be that skillful employee, who knows very well the procedures, puts them effectively into practice and yet has time to specialize and keep in touch with the latter methodologies developed by audit scholars. He is the key element, the relationship manager. And the audit process depends on many variables, but above all, stands the auditor.

Key Words: auditing risks

There are not so many studies and researches about auditing in Romania. This field is quite new and ready to reveal its secrets. Our professionals must permanently keep in touch with their colleagues from developed countries, with great tradition in this activity. However, it is also true that they have to know the origins of the concept, the manner it appeared and developed, and the mechanism behind it. Therefore, in this paper we try to highlight some aspects about auditing, as they are referred to in international accounting literature.

Everything is about people and auditing is not an exception. Negotiations, discussions over a specific issue are “fluid”, so they change repeatedly. This continual redefinition refers not only to the object of the negotiation, but also to the negotiation roles and relationships between participants. The actions and expectations of the chief financial officer seem to define the auditor's role and the relationship's parameters. The auditor expresses the desire of building an “ideal” relationship where to assume the role of the “expert advisor” rather than that of a “police officer”. Nevertheless, he does not have a certain strategy to convert the collaboration into a proactive relationship.

Auditor-client management negotiation research is still understudied. Accounting literature mostly concentrates on the auditor. However, a negotiation involves at least two parts. As Lewicki, Barry & Saunders (2006) point out, it was only in the recent years when researchers started to examine these negotiations in the context of a relationship where the participants have a substantial history and anticipate a long-term cooperation.

McCracken, Salterio & Gibbins (2008) talk about the so-called “shadow negotiation”. This pertains to a negotiation of the roles and actions that parties can take, simultaneously with the negotiation itself over real issues. In the same paper, the three authors initiated a study over several companies and interviewed auditors and chief financial officers. Cooper & Robson (2006) undertook a similar research. They both “examine how accounting and audit decisions are made”. The results showed that the chief financial officers define the roles and the relationship. Some of them consider this collaboration as being proactive if auditors are consulted before operating the transactions, in order to ensure that the financial statements are of “high quality”. This perspective is highly appreciated by the auditors, who wish all their professional relationships to follow this pattern.

Some other chief financial officers position the auditors into a “reactive” relationship. They consider the financial statements as being theirs and consequently, they do not consult the auditors regarding the correct exercising of the accounting principles and regulations. This is the reason for not identifying in time

inconsistencies of any kind; the financial officer is strongly committed to his position and thus, the negotiation process is even more difficult. While some auditors reject the role of “police officer” and the reactive relationships, others gladly accept them, with the belief that, in time, they can change the situation in their favor.

In the end, no matter the case, auditors remain the relationship managers, responsible with keeping the client satisfied and the cooperation in a good state (Kolb & Williams, 2000).

One can describe or characterize an activity like auditing in many ways. Peecher, Schwartz & Solomon (2007) chose to emphasize four dimensions of the audit, which are:

- audited companies use new business models (that is, a description of how the entity intends to create value in the marketplace; it includes that unique combination of products, service, image and distribution, but also the organization of the personnel and the operational infrastructure used in order to accomplish the tasks), processes and business strategies;
- there is major concern and responsibility for detecting fraud resulting in misstated financial statements;
- although not so frequent, the audit failures are due especially to the inadequate control of the risk elements;
- it implies planning and organizing audit quality control for every individual engagement.

The environment of activity and the context of business have an enormous impact on the company, on risks in general, and on audit risk in particular. By audit risk, we mean the probability that the auditor will issue an inappropriate opinion when the financial statements contain one or more misstatements (like departures from generally accepted accounting principles).

Despite the business model complexity and market threats, the auditor must opine on the veracity of the financial statements. They capture retrospective and prospective consequences of the business through numerous estimates and complex documentation. The auditor has to develop new methods in order to verify their reasonableness as well as strategies for acquiring additional, sufficient evidence to sustain their accuracy.

At the beginning, audits focused on detecting bookkeeper fraud. Later, as companies developed and began to emerge as popular business structures, auditors focused on honest presentation of income, according to accounting principles. Such desideratum can be compromised by intentional or unintentional misstatements. Generally, when considering the latter situation, the auditors assume their responsibility. Otherwise, they try in a variety of ways to minimize responsibility. Intentional distortion of the reality can arise when an employee illegally misappropriates assets, but even more important and serious, when management appeals to such behavior, and more, they distort the financial statements.

Some reasons for most of the auditor judgment errors are:

- failure to sufficiently understand the client’s business;
- failure to verify management’s observations and explanations;
- lack of exercising professional skepticism on unusual or last-minute transactions;
- inadequate appreciation and evaluation of risks.

The last deficiency is a consequence of the others, especially of the first one. Risk is inevitable if the auditor cannot obtain an overall and deep understanding of his client’s business.

.....The first audit risk model (ARM) in equation form appeared in 1972 (AICPA, 1972) as it follows:

$$\text{Audit Risk (AUR)} = \text{Inherent Risk (IR)} \times \text{Control Risk (CR)} \times \text{Detection Risk (DR)},$$

where:

- AUR – the risk that the auditor expresses an inappropriate opinion when the financial statements are not properly drawn and consequently, they can influence the economic decisions of users;
- IR – the susceptibility of a possible error assuming that there were no internal controls;
- CR – the risk that a significant misstatement which could appear in documents, individually or aggregated with others, will not be prevented or detected and corrected in time by the company’s internal control;

- DR – the risk that the auditor will not identify important distortions individually or when aggregated.

Sometimes IR and CR combine into a single term, which refers to the risk that the financial statements are inaccurate before audit is performed.

This model was designed in order to help auditors to select the proper size of the sample that would achieve audit objectives. Often, DR is decomposed in other two terms: analytical procedures and tests of details. On their turn, these so-called tests of details divide into sampling and non-sampling risks. The latter do not pertain to the model because they are determined by factors that lead to an incorrect opinion of the auditor, for other reasons than vicious sampling. On the other hand, risks due to sampling arise because of the possibility that the auditor's deduction, based only on the sample, may be different from the conclusion reached if the entire population were part of the same audit procedure (IAASB, 2005).

Consequently, audit risk may be determined both by previous distortions in financial statements and by the likelihood that the auditor does not detect these distortions, if they exist, during the audit process.

There is a logical issue about risk. It refers to the extent in which the client is aware of the methodology that will be applied by the auditor. In such situations, those particular clients who deliberately wish to deceive the auditor, know exactly how and where to place misstatements so that they may go undetected.

In time, researchers have identified several imperfections of the model. Therefore, they developed the so-called Strategic-Systems Auditing, an appropriate and necessary means of enhancing audit quality.

Not so long ago it would have been inconceivable for an audit firm to aim national and international acknowledgement by offering a standard product rather than a highly specific professional service. Colin Sharman, the international chairperson of KPMG, a global network of professional firms providing audit, tax and advisory services, recently proposed the ideal of standardization. He talks about achieving uniform, global brand awareness, a common vision of the organization and a common set of products and processes. "That is equivalent to what we want to do with consultancy services", Sharman commented.

The world of auditing and accounting has changed significantly. Only a short while ago, the consultants of the major audit firms assumed that their clients wanted a service that "would delve into the specificities of their problems, coming up with tailor made solutions that related to their identity, their products, their history, their corporate culture and their managerial needs" (Hopwood, 1998, p. 515). However, as the author himself says, things have changed. Apparently, clients want to be the same. They are now solution oriented rather than problem focused. Consequently, honor and glory can be attained by being like everyone else. The same philosophy exists in another major audit firm, Ernst and Young: "we help organizations look at what needs to go right in order to achieve their strategic business objectives as well as managing the threats of what could go wrong". You have to think positive, to find solutions and to repeat the algorithm.

Likewise, companies in audit industry have challenged all aspects of the traditional audit. Professionalism has been replaced with business sharpness. Ernst and Young, for instance, look for people with a broad range of skills, and not necessarily with professional education. They will have the opportunity to specialize and to gain experience as they work.

In practice, audit firms are seen as complex and highly structured networks of rules and standard operating procedures.

In the 1980s, researchers and scholars debate about the role of structure and qualification in audit process. Because of the rapid growth of the audit procedures and practices, the expansion of the personnel, improvements in technology and the exigencies of reducing costs, accounting firms began to design and implement highly structured processes. Bamber, Snowball & Tubbs (1989, p. 286) describe structure as "the arrangement of people, tasks, and authority to achieve more calculable and predictable control over organizational performance". Cushing & Loebbecke (1986) consider that audit structure includes organizational and technological arrangements, which on their turn comprise prescribed audit tools and decision aids. In other words, audit structure suggests a mechanical approach to decision-making process, which narrows the set of actions available to individual auditors in certain circumstances.

The development and expansion of the audit structures marked many aspects of the audit process, for example: refinements of statistical sample, risk detection tests, analytical procedures, decision-making aids, and going concern evaluations (that is, a company's ability to make enough money to stay afloat, to continue to operate. If a company is not a going concern, it means the company has gone bankrupt).

Therefore, audit structure was often viewed as a consequence of top-down dictates from the management of large audit firms trying to minimize the risk of serious judgment errors within the audit process. Even so, in order to turn audit into a successful activity it is necessary to provide more value to the clients. Hence, scholars reached the conclusion that audit must become part of the “mosaic of risk management” (Knechel, 2007).

Around 1994, a very simple concept emerged among the most influential members of the academic and audit community: “Business risk drives audit risk” (Eilifsen, Knechel & Wallage, 2001).

Onwards we illustrate the concept (see Fig. 1), adapted from Lemon, Tatum & Turley (2000).

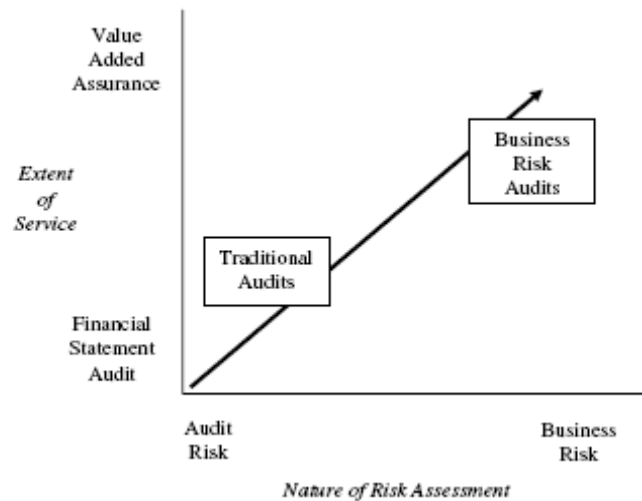


Fig. 1. Risk in audit process

Source: Lemon, Tatum & Turley, 2000

This notion was not something new and unprecedented. Nevertheless, it seems that it was simply the perfect time for it to be acknowledged and appreciated for what it really is. Consequently, anything that has the potential to increase risk and to determine the organization not to meet its objectives is seen as a source of increased audit risk. Understanding the essence and the importance of this notion, many audit firms, starting from the most representative like Ernst & Young, KPMG or PricewaterhouseCoopers put it into practice. For instance, Ernst & Young undertook their Audit Innovation project; KPMG began development of The Business Measurement Process. Thus, they led to significant changes in the way an audit procedure was planned and conducted.

Analyzing the results gathered from surveys in United Kingdom, United States and Canada, Lemon identified the following reasons for adopting an audit risk methodology:

- improve audit effectiveness and efficiency;
- keep up with technological change;
- add value to client service;
- encourage international cooperation;
- facilitate product differentiation;
- reduce auditor engagement risk.

Therefore, the auditor needs to see the entire organization and its environment in order to understand the nature of the challenges to be faced and solved.

After ABREMA (Activity Based Risk Evaluation Model of Auditing), a normative model of financial statement auditing, there are five stages in an audit engagement. Each stage corresponds to a critical decision made by the auditor during the audit process. The stages and the decisions made are:

- Client acceptance/retention stage - based on a preliminary knowledge of the client's business, the auditor undertakes several activities so as to determine whether to accept or reject a prospective client (or retain or relinquish an existing client) - the accept/reject decision;
- Audit planning stage - based upon a detailed knowledge of the client's business, the auditor undertakes various activities in order to decide upon an appropriate audit approach for each account balance;
- Control testing stage - applicable only where the audit process includes reliance on one or more control procedures. In such cases, the auditor gathers evidence regarding the effectiveness of the control. Where the controls are not as effective as was believed in the previous stage, the auditor would change the planned audit approach. The corresponding decision is whether one should continue to trust the management's internal control procedures;
- Substantive testing stage – the auditor gathers substantive evidence (regarding the completeness, validity and accuracy of the documents) of individual account balances and transactions, the primary objective of which is to determine the extent of misstatements;

Opinion formulation stage – the auditor expresses an opinion on the financial statements as a whole (the audit opinion decision), based on the evaluation of the extent to which the financial statements are consistent with his knowledge of the entity, including his conclusions concerning the misstatements identified, if any.

Consequently, the main objective of the auditor is to form and communicate to the users of the financial statements an opinion on their reliability and veracity, counting on audit evidence of sufficient quantity and appropriate quality.

As a conclusion, we can say there still are many issues that need to be clarified, in order to reach some common ground and to combine successfully the theoretical concepts with practice.

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