

Select Factors Governing Quality of Statutory Financial Audit: A Comparative Study

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Abstract

The study identifies three pertinent areas in an audit procedure where statutory auditors depend upon other internal or external parties for developing audit plan or collecting audit evidences. They are, 'using the work of internal auditors', 'external confirmations' and 'using the work of an auditor's expert'. Auditing standards governing these three distinct issues in three different countries, the United States of America (USA), the United Kingdom (UK) and India have been considered and a comparative analysis among their requirements has been made. The study observes that comparable standards governing 'using the work of internal auditors', 'external confirmations' and 'using the work of an auditor's expert' are almost identical. However, the standards in UK and India with respect to these issues are more comprehensive than that of USA.

Keywords: Internal Auditor, External Confirmations, Auditor's Expert, USA, UK, India, Comparative Analysis

1. Introduction

As per Section 143 of Indian Companies Act, 2013, all the companies in India are required to adopt certain policies and procedures for ensuring the orderly and efficient conduct of business. It includes adherence to company's strategies, protection of company's assets, prevention of frauds, accuracy and completeness of accounting records and timely preparation of financial statements. The framework designed within the company for achieving these goals is known as 'Internal Financial Control'. As per Section 42 of Indian Companies (Amendment) Bill, 2016, its name has been changed to 'Internal Financial Control with Reference to Financial Statements'. When, statutory auditors are engaged in a company as per the provision of Section 139 of Indian Companies Act, 2013 and Indian Standard on Auditing (SA)-210 titled, 'Agreeing the Terms of Audit Engagement', they first consider the internal control framework within the company. If the company has a strong internal control, the auditor can take up a lax audit procedure and vice versa (Zhang, et. al., 2006). Hence, auditors' approach towards a particular engagement depends upon severity of internal control framework. Now, the question arises as to how the auditor can comprehend the internal control structure of the company. Here, the internal auditor steps in. Their report on internal financial control is usually referred by the external auditor for deciding the nature, timing and extent of audit procedures. Auditors' responsibilities with respect to interaction with internal auditors are discussed in SA-610 titled, 'using the work of internal auditors' issued by the Institute of Chartered Accountants of India (ICAI).

Based on auditors' assessment of internal control framework, they prepare a comprehensive plan and proceed with actual audit procedure for collecting sufficient and appropriate audit evidences. Out of many mechanisms of collecting evidences, 'external confirmations' and 'using the work of an auditor's expert' are noteworthy. Statutory auditors collect confirmations from external parties, such as debtors and creditors and account balances mentioned in the financial books (McConnell & Schweiger, 2008). The entire procedure is governed by SA-505 titled, 'External Confirmations'. On the other hand, statutory auditor employs an auditor's expert as a part of the engagement team. Their main job is to verify certain areas in an engagement where statutory auditors do not have sufficient expertise (Boritz, et. al., 2014). Statutory auditor can use the services of an auditor's expert as per the provisions of SA-620 titled, 'Using the work of an auditor's expert'.

The SAs in India and auditing standards in some other developed and developing countries of the world are designed in line with International Standards on Auditing (ISAs) issued by International Auditing and Assurance Standards Board (IAASB) under the International Federation of Accountants (IFAC). However, there can be some inherent differences in the language or requirements in the standards due to local, societal and economic differences. The current study is an attempt to comparatively analyse the standards governing 'using the work of internal auditors', 'external confirmations' and 'using the work of an auditor's expert' among a few countries including India.

2. Objective

Major objective set for the current study is to comparatively analyse the requirements relating to 'using the work of internal auditors', 'external confirmations' and 'using the work of an auditor's expert' in a few countries

including India.

3. Methodology

Nature of Study	Conceptual		
Nature of Research	Exploratory in Nature		
Nature of Data	Secondary		
Sources of Data	Books, Journal Articles, Legislations, Working Papers, Web based materials		
Period of Data Collection	January 2015 to May 2015		
Nature of Analysis	Comparative analysis of auditing standards among a few countries		
Parameters for Comparative Analysis	(a) Using the Work of Internal Auditor (b) External Confirmations (c) Using the Work of Auditor's Expert		
Countries Selected for Comparative Analysis	(a) The United States of America (b) The United Kingdom (c) India		
Sampling Method used while Selection of Countries	Judgemental Sampling Technique (Malhotra & Dash, 2011)		
Sample Frame for Selection of Countries	Lists of countries ranked as per their Gross Domestic Product (GDP) calculated as per Purchasing Power Parity (PPP) theory published by World Bank (World Bank Database, 2012), Central Intelligence Agency (CIA) (CIA World Fact Book, 2010) and International Monetary Fund (IMF) (IMF World Economic Outlook Database, 2012) at the end of 2015. Top 10 countries in those lists are used as the sample frame.		
Brief Overview about the Countries	USA Among the countries selected, USA was ranked first. A high level of industrial output and corporate growth in this country required US regulatory bodies to implant a good auditing system. However, out of control corporate malpractices (e.g. Enron, WorldCom) eventually proved insufficiency of quality audit in the country (Thibodeau & Frier, 2010).	UK Though countries like Japan or Russia was ranked ahead of UK in terms of GDP, regulatory authorities in UK first talked about global convergence of financial reporting framework and standardization in statutory audit regulations all over the world. The concept of Audit Committee which is one of the pillars of modern corporate governance mechanism was first emerged in UK.	India India is the 3 rd largest economy in the world. After independence in 1947, India's growth in industrial and service sector was phenomenal. Protection of a global stakeholder base has become all the more imperative for Indian companies. Auditing, which is a tool for protection of stakeholders' interest should be sharpened.
Standards referred for Comparative Analysis	USA (Standard Issuing Authority: The American Institute of Certified Public Accountants)	UK (Issuing Authority: The Financial Reporting Council)	India (Issuing Authority: The Institute of Chartered Accountants of India)
(a) Using the Work of Internal Auditor	Statement of Auditing Standard (SAS) 128 Clarified Auditing Section (AU C) 610 titled, 'Using the Work of Internal Auditors'	International Standard on Auditing (ISA) (UK and Ireland) 610 titled, 'Using the Work of Internal Auditors'	Standard on Auditing (SA) 610 titled, 'Using the Work of Internal Auditors'
(b) External Confirmations	SAS 122 (AU C 505) titled, 'External Confirmations'	ISA (UK and Ireland) 505 titled, 'External Confirmations'	SA 505 titled, 'External Confirmations'
(c) Using the Work of Auditor's Expert	SAS 122 (AU C 620) titled, 'Using the Work of an Auditor's Specialist'	ISA (UK and Ireland) 620 titled, 'Using the Work of an Expert'	SA 620 titled, 'Using the Work of an Auditor's Expert'

4. Comparative Analysis of Factors governing Quality of Statutory Financial Audit

4.1 Inferences on 'Using the Work of Internal Auditors'

- ◆ The standard governing use of work of internal auditors in USA, UK and India are SAS-128 (AU-C 610), ISA (UK & Ireland)-610 and SA-610 respectively.
- ◆ The provisions of the governing standards in all three countries have some differences among them. In all three countries, the external auditor is required to evaluate the competence and independence of internal auditors. They should also decide the nature, extent, and timing of internal auditors' work.
- ◆ In some circumstances, the external auditor may use internal auditors for some specific purposes. In UK and India, the external auditor should measure the adequacy of internal auditors' work. In UK, internal auditors'

work is required to be directly supervised and reviewed by the external auditors. All important aspects about internal auditors' work are required to be documented.

- ◆ The applicable standard in USA has mandated an external auditor to communicate those charged with governance the degree of assistance obtained from the internal auditors. In USA, the external auditor should plan their audit procedure based on the degree of involvement of internal auditors and should not reduce sufficient involvement in the audit process. However, such regulatory provisions are not applicable in other two countries (*Refer to Table 1*).

Table 1: A Comparative Study on quality control framework among USA, UK and India

Countries Parameters	The United States of America	The United Kingdom	India
Parameter 1: Using the Work of Internal Auditor			
A. Governing Standard	SAS-128 (AU-C 610) titled, 'Using the Work of Internal Auditors'	ISA (UK & Ireland)-610 titled, 'Using the Work of Internal Auditors'	SA-610 titled, 'Using the Work of Internal Auditors'
B. Requirements	<ul style="list-style-type: none"> ◆ Evaluation of competence and independence of internal auditors; ◆ Determining nature, extent and timing of internal auditors' work; ◆ Communication with those charged with governance; ◆ Design of audit procedures based on extent of dependability on internal auditors; ◆ Requesting internal auditors for direct assistance; ◆ Not reducing sufficient involvement. 	<ul style="list-style-type: none"> ◆ Appraisal of competence and independence of internal auditors; ◆ Deciding on nature, extent and timing of internal auditors' work; ◆ Measuring adequacy of internal auditors' work; ◆ Direct assistance from internal auditors; ◆ Supervision and review of internal auditors' work; ◆ Documentation. 	<ul style="list-style-type: none"> ◆ Assessment of adequacy of internal auditors' work; ◆ Determining nature, extent and timing of internal auditors' work; ◆ Evaluation of competence and independence of internal auditors; ◆ Using internal auditors for specific purpose.
Parameter 2: External Confirmations			
A. Governing Standard	SAS-122 (AU-C 505) titled, 'External Confirmations'	ISA (UK & Ireland)-505 titled, 'External Confirmations'	SA-505 titled, 'External Confirmations'
B. Requirements	<ul style="list-style-type: none"> ◆ Maintaining absolute control on external party requests; ◆ Dealing with management's refusal to allow external confirmations; ◆ Checking reliability of responses; ◆ Acquiring evidences in case of non-response ◆ Requiring written confirmations; ◆ Investigating possibilities of misstatement, if written confirmations are not obtained; ◆ Avoiding negative confirmations. 	<ul style="list-style-type: none"> ◆ Persisting absolute control on external party requests; ◆ Coping with management's refusal to allow external confirmations; ◆ Validating reliability of responses; ◆ Collecting evidences in case of non-response ◆ Requiring written confirmations; ◆ Inquiring possibilities of misstatement, if written confirmations are not obtained; ◆ Avoiding negative confirmations; ◆ Evaluation of sufficiency and appropriateness of 	<ul style="list-style-type: none"> ◆ Maintaining complete control on external party requests; ◆ Dealing with management's rejection to allow external confirmations; ◆ Checking reliability of responses; ◆ Gathering evidences in case of non-response ◆ Requiring written confirmations; ◆ Investigating possibilities of misstatement, if written confirmations are not obtained; ◆ Avoiding negative confirmations; ◆ Evaluation of adequacy

		confirmations received through this mode.	and suitability of confirmations received through this mode.
Parameter 3: Using Work of Auditor's Expert			
A. Governing Standard	SAS-122 (AU-C 620) titled, 'Using the Work of an Auditor's Specialist'	ISA (UK & Ireland)-620 titled, 'Using the Work of an Expert'	SA-620 titled, 'Using the Work of an Auditor's Expert'
B. Requirements	<ul style="list-style-type: none"> ◆ Known as Auditor's specialist; ◆ Requiring help from specialist; ◆ Modifying nature, timing and extent of audit procedure based on nature of work performed by the specialist; ◆ Evaluation of competence and independence; ◆ Understanding in the field of expertise; ◆ Signing agreement with specialist; ◆ Assessing adequacy of specialist's work; ◆ Not referring the work of specialist. 	<ul style="list-style-type: none"> ◆ Known as Auditor's expert; ◆ Requiring help from expert; ◆ Changing nature, timing and extent of audit procedure based on nature of work performed by the expert; ◆ Evaluation of capability and independence; ◆ Understanding in the field of knowledge; ◆ Signing accord with expert; ◆ Evaluating adequacy of expert's work; ◆ Not referring the work of expert. 	<ul style="list-style-type: none"> ◆ Known as Auditor's expert; ◆ Requiring help from expert; ◆ Modifying nature, timing and extent of audit procedure based on nature of work performed by the expert; ◆ Evaluation of competence and self-governance; ◆ Understanding in the field of skill; ◆ Signing agreement with expert; ◆ Assessing adequacy of expert's work; ◆ Not referring the work of expert.

[Source: Relevant Sections of SAS 128 (AU C 610), SAS 122 (AU C 505), SAS 122 (AU C 620), ISA (UK and Ireland) 610, ISA (UK and Ireland) 505, ISA (UK and Ireland) 620, SA 610, SA 505, SA 620]

4.2 Inferences on 'External Confirmations'

- ◆ External confirmations are an important source of audit evidence. Quality of external confirmations ensures quality of auditors' conclusion on financial statements. In USA, UK and India, the process of obtaining external confirmations is monitored by SAS-122 (AU-C 505), ISA (UK & Ireland) 505 and SA-505.
- ◆ As per the provision of applicable standard in all three countries, statutory auditors should maintain absolute control on confirmation requests. If management refuses to allow them to obtain such information, they should take appropriate actions. The auditors in all three countries should also evaluate the reliability of information collected through this mode and collect appropriate evidences for non-response or oral response. The auditor should seek for written confirmations from the external parties. If they fail do it, the auditors must evaluate the reasons behind it.
- ◆ Auditors in all three countries should normally avoid negative confirmations. In UK and India, they should also evaluate sufficiency and appropriateness of audit evidences collected through this route (*Refer to Table 1*).

4.3 Inferences on 'Using the Work of Auditor's Expert'

- ◆ The statutory auditors do not have expertise in all the fields. Therefore, they have to depend upon someone who has an expertise in the field where statutory auditors' are less knowledgeable. Auditors' use of the work of an expert is guided by applicable standards in three select countries. They are SAS-122 (AU-C 620) [USA]; ISA (UK & Ireland)-620 [UK], and SA-620 [India].
- ◆ The provisions of all three standards are same. However, in the USA, the persons with special knowledge are known as Auditor's Specialist, while in UK and India, they are called Auditor's Expert. Statutory auditors take help from these experts in those areas where they have little expertise. Moreover, statutory auditors should have at least some knowledge in their fields.
- ◆ Statutory auditor is required to design their audit procedure based on nature and extent of work of these experts to be used in the auditing process. They should also evaluate competence and independence of these experts. Statutory auditors in all three countries should sign an agreement with the expert, but they should not refer the work of the expert in their audit report (*Refer to Table 1*).

5. Conclusions

Evaluating internal control system relating to financial statements in the client company is the important step in an audit procedure as a statutory auditor may depend upon the work done by internal auditors. As soon as the audit process begins, statutory auditor starts collecting sufficient and appropriate evidences based on well chalked out plan. Collecting external confirmations and using the work of an auditor's expert are two mechanisms of audit activities. After a comparative review of governing standards of these three issues in USA, UK and India, some differences among them have been identified. Firstly, titles of the standards in three different countries are slightly different from one another. With respect to 'using the work of internal auditor', the requirements in UK and India are almost similar. It enforces more supervision on internal auditors' work by the external auditor. However, in USA, the standard requires an external auditor to communicate the degree of assistance received from internal auditors to those charged with governance. Requirements on 'external confirmations' in USA, UK and India are similar. However, UK and India put more emphasis on checking the reliability of external confirmations. While the provisions on 'using the work of an auditor's expert' are comparable in three countries under consideration, the names of an expert is different in different countries. The terminology, auditor's expert is coined in Indian auditing standard. However, in USA and UK, they are called as auditor's specialist and an expert respectively. The study finally concludes that Indian regulation with respect to 'using the work of internal auditors', 'external confirmations' and 'using the work of auditors' expert' are framed in line with international requirements and is not lagging behind the requirements in USA or UK.

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