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INTERNAL AND EXTERNAL FACTORS GOVERNING QUALITY OF STATUTORY FINANCIAL AUDIT: A PERCEPTUAL STUDY

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ABSTRACT

The study reviews the existing Standards on Auditing (SAs) issued by the Institute of Chartered Accountants of India governing 'using the work of internal auditors', 'external confirmations' and 'using the work of an auditors' expert' and identifies 12 critical issues that may have significant impact on quality of statutory financial audit. Opinions of 227 Chartered Accountants (CAs) and 146 Students pursuing Chartered Accountancy course have been collected through a field survey using a close ended structure questionnaire. Respondents' opinions are analysed using proportion of respondents with different degrees of agreement and their mean scores for different issues contained in the questionnaire. The study finds that auditors should necessarily check the internal control system present in the client company before starting the actual work. A strong Audit Committee could facilitate that purpose. Scientific design of confirmation requests is also necessary. Finally, it is inferred that existing SAs governing the aforesaid issues are adequate. However, its proper enforcement is needed to enhance the quality of statutory financial audit.

KEYWORDS

auditors' expert, external confirmations, internal audit, mean score, percentage analysis, statutory audit.

INTRODUCTION

Statutory financial auditors in India are appointed as per Section 139 of the Indian Companies Act, 2013. Scope of audit is determined in terms of audit engagement, relevant provisions of statute and announcement/ pronouncement of the Institute of Chartered Accountants of India. It may not become possible for the auditors always to conduct for a comprehensive audit because of limited time frame set for completing the entire audit process. As a result, the auditors' responsibilities of attesting the financial statements become even more difficult and auditors look for assistance from parties internal as well as external to the organisation. In a broad framework, they include internal auditors, external third parties and auditors' expert. Internal auditors are appointed by the management or those charge with governance in an audited entity. Their main purpose is to assure the effectiveness of internal control mechanism of the company. Usually, they work in conformity with Audit Committee (Krishnan, 2010). The external auditor makes their initial audit plans after evaluation of internal control system including internal audit. Hence, competence and integrity of internal auditor is of considerable importance to the external auditors. However, as internal auditors are appointed by management, a complete independence may not be achieved and external auditors may not fully rely upon their reports (ICAI, SA-610). Sufficient and appropriate evidences are often collected from external third parties who have business relationship with the client entity. It may include banks, debtors and creditors of the audited entity. Keeping in mind risk of material misstatement, the auditor selects the confirming parties and designs their confirmation requests to gather documentary evidence on the material accuracy and appropriateness of financial reporting framework in the financial statements from an independent third party (ICAI, SA-505). In different phases of audit procedures, the auditor may encounter certain situations, such as valuation of intangible assets, accounting estimates, etc. where accounting knowledge of the auditors may not be effective to collect sufficient and appropriate evidences (Krishnan & Visvanathan, 2007). In those cases, the audit team may appoint an auditors' expert whose purpose is to apply its specialised knowledge and assure management's contention in financial statements. While integrity and competence of auditors' expert is of great importance to the auditor, they cannot rely completely on auditors' expert work (ICAI, SA-620).

In the advent of recent corporate accounting scandals, it was observed that internal and external factors governing quality of audit were not that effective (Janvrin, et. al., 2010). One of the probable reasons could be inadequacy of the existing Standards on Auditing (SAs) and other regulations governing these issues. The current study is an attempt to analytically examine the perceptions of professional accountants and students pursuing professional courses on select issues concerning internal audit procedures, external party confirmations and role of auditors' expert.

REVIEW OF LITERATURE

Sl. No.	Author(s)	Theme of the Study Pertaining to Current Research	Main Findings of the Study
1.	Krishnan (2005)	The paper examined the association between quality of audit committee and the quality of corporate internal control.	Independent audit committees and audit committees with financial skill are considerably less expected to be connected with the frequency of internal control problems.
2.	Raghunandan, et. al. (2001)	The study analysed the association between audit committee structure and the committee's interaction with internal auditing.	Committees comprised exclusively of independent directors and with at least one member having an accounting or finance backdrop are more likely to have longer meetings with the chief internal auditor; offer confidential access to the chief internal auditor; and review internal audit suggestions and results of internal auditing.
3.	Janvrin, et. al. (2010)	The paper examined confirmation-related evidence from relevant Security and Exchange Commission (SEC) Accounting and Auditing Enforcement Releases (AAERs)	Fraud might have been diagnosed if auditors had established additional matter such as material cash balances, marketable securities, and terms of significant transactions.
4.	Bame-Aldred et. al. (2013)	The paper reviewed the existing literature on the external auditors' reliance on internal audit functions, identifies gaps in the literature, and proposed a sequence of research questions aimed at closing these gaps.	The environment in which external auditors took reliable decision was complex. It involved several factors that must be considered at the same time.
5.	Krishnan & Visvanathan (2007)	The current study took an attempt to find out the justification of the definition of accounting expert set by the SEC and its impact on financial expertise of Audit Committee.	An Audit Committee's financial expertise is positively associated with conservatism when financial expertise is practised only by the accounting experts.

SUMMARY OF PAST STUDIES

Literature reviewed so far cover the following areas:

- (i) Role of internal control framework in statutory audit operations;
- (ii) Composition of Audit Committee in strengthening internal control framework;
- (iii) Process of collection external confirmations in audit procedure and implications for standard setters;
- (iv) Relationship between external and internal auditing; and
- (v) Implications of accounting expert in statutory audit procedure.

RESEARCH GAP

It is evident from the past studies that there is a need for empirical study considering different issues which aid the audit procedure. Specific gaps identified from review of literature are:

- (i) There is no sufficient number of empirical researches in the related field;
- (ii) Studies considering role of internal auditor, external third parties and auditors' expert on audit procedure is not made so far;
- (iii) Perceptions of professional accountants and students pursuing professional accounting course together have not been considered in preceding literature.

OBJECTIVES

Major objectives of the study in the current chapter are as follows:

- 1. To analyse opinions of Chartered Accountants (CAs) and Students on issues governing Quality of Statutory Financial Audit (Refer to Section 5.2);
- 2. To identify the importance associated with each variable governing Quality of Statutory Financial Audit (Refer to Section 5.3).

DATA AND METHODOLOGY

Nature of Study	Empirical		
Nature of Research	Exploratory Research Design		
Nature of Data	Primary as well as Secondary		
Secondary Data	Books, Journal Articles, Legislations collected from several reputed libraries in Kolkata		
Primary Data	Perceptions of Respondents		
Number of Variables	12 (Refer to (Table 1)		
Selection of Variables	SA-610 titled, 'Using the work of Internal Auditors', SA-505 titled, 'External Confirmations' and SA-620 titled, 'Using the Work of an Auditor's Expert' have been considered initially for selection of variables. The critical areas in these standards have been identified and practicing CAs in Kolkata were consulted to get their views on those issues. Finally, 12 such issues were selected which may have some influence on overall quality of audit. They are considered as the variable of the current study.		
Survey Tool	Pre-tested Close Ended Structured Questionnaire		
Measurement Scale	Likert 5 Point Scale [1: Strongly Disagree (SD); 2: Disagree (D); 3: Neutral (N); 4: Agree (A); and 5: Strongly Agree (SA)] (Kothari, 2010)		
Survey Area	Kolkata, West Bengal, India		
Survey Period	June, 2015 to December, 2015		
Respondents	(a) Chartered Accountants in Practice; (b) Students pursuing Chartered Accountancy Course		
Method of Sampling	Non-Probability Convenience Sampling Technique (Ho, et. al., 1997)		
Data Collected	Respondent Groups	Initial Sample	Final Sample
	Chartered Accountants	250	227
	Students	200	146
	Total	450	373
Data Analysis	Objectives	Statistical Tools	
	Analysing opinions of respondents on issues governing audit procedure	Percentage (%) Analysis	
	Identifying the importance associated with each variable governing audit procedure	Mean score	
Statistical Software	SPSS 20.0		

TABLE 1: VARIABLES SELECTED

Variable Code	Variables
V ₁	Mandatory checking of internal control system by statutory auditors
V ₂	Statutory auditors' dependence on internal auditor
V ₃	Excessive reliance placed on internal auditors' work
V ₄	Testing competence and integrity of internal auditor
V ₅	Strengthening Audit Committee
V ₆	Thorough checking of internal auditors' report on risk of material misstatement
V ₇	Lack of enforceability of standards governing internal audit operations
V ₈	Scientific designing of confirmation requests
V ₉	Applying alternative method of getting confirmation if the parties are in legal dispute
V ₁₀	Necessity of confirmation for accounts receivable and accounts payable balance only
V ₁₁	Statutory auditors' responsibility even if he is relying on the work of auditor's expert
V ₁₂	Evaluation of competence and independence of auditor's expert

ANALYSIS AND DISCUSSION

DEMOGRAPHIC PROFILE OF RESPONDENTS

A brief demographic profile of respondents for this chapter is given in the following table.

TABLE 2: DEMOGRAPHIC PROFILE OF RESPONDENTS

Demographic Profile Based on Gender					
Male	%	Female	%		
367	98.4	6	1.6		
Demographic Profile Based on Age					
Young (Age less than 30 years)	%	Middle Aged (Age between 30 and 50 years)	%	Experienced (Age more than 50 years)	%
159	42.6	125	33.5	89	23.9
Demographic Profile Based on Occupation					
CAs	%	Students	%		
227	60.9	146	39.1		

(Source: Compilation of Field Survey Data using SPSS 20.0)

FINDINGS

- ◆ Majority of respondents in the final sample are male, though it is not deliberate;
- ◆ Maximum percentage of respondents be in the middle aged group;
- ◆ Majority of respondents in the final sample are CAs.

ANALYSING OPINIONS OF RESPONDENTS ISSUES GOVERNING QUALITY OF STATUTORY FINANCIAL AUDIT USING PERCENTAGE (%) ANALYSIS

The questionnaire is designed on a 5–point scale. Hence each statement in the questionnaire corresponds to 5 different degrees of agreement. They are Strong Disagreement (SD); Disagreement (D); Neutral Approach (N); Agreement (A); and Strong Agreement (SA) (Refer to Section 4). During the field survey, each respondent has shown their level of agreement with a particular statement by marking in any one of those five fields. After collection of data, proportion of respondents under each level of agreement for a particular statement is calculated. The level of agreement at which the proportion of the final sample or sample of individual categories of respondents is highest is duly noted. It represents the opinion of the final sample on the particular variable. Let us now analyse the opinions of select respondent categories and final sample on variables selected for the study:

TABLE 3: PERCENTAGE OF RESPONDENTS IN DIFFERENT AGREEMENT LEVELS

Variable Code	Variables	Category	SD	D	N	A	SA
V ₁	Mandatory checking of internal control system by statutory auditors	CAs	0.0%	0.4%	1.3%	78.4%	19.8%
		Students	0.0%	3.4%	4.8%	48.6%	43.2%
		Total	0.0%	1.6%	2.7%	66.8%	29.0%
V ₂	Statutory auditors' dependence on internal auditor	CAs	0.9%	18.1%	11.0%	64.3%	5.7%
		Students	7.5%	33.6%	11.6%	40.4%	6.8%
		Total	3.5%	24.1%	11.3%	55.0%	6.2%
V ₃	Excessive reliance placed on internal auditors' work	CAs	0.4%	4.4%	5.3%	73.6%	16.3%
		Students	4.8%	11.6%	3.4%	42.5%	37.7%
		Total	2.1%	7.2%	4.6%	61.4%	24.7%
V ₄	Testing competence and integrity of internal auditor	CAs	0.0%	0.4%	1.3%	78.4%	19.8%
		Students	0.0%	3.4%	4.8%	48.6%	43.2%
		Total	0.0%	1.6%	2.7%	66.8%	29.0%
V ₅	Strengthening Audit Committee	CAs	0.9%	18.1%	11.0%	64.3%	5.7%
		Students	7.5%	33.6%	11.6%	40.4%	6.8%
		Total	3.5%	24.1%	11.3%	55.0%	6.2%
V ₆	Thorough checking of internal auditors' report on risk of material misstatement	CAs	0.4%	4.4%	5.3%	73.6%	16.3%
		Students	4.8%	11.6%	3.4%	42.5%	37.7%
		Total	2.1%	7.2%	4.6%	61.4%	24.7%
V ₇	Lack of enforceability of standards governing internal audit operations	CAs	0.0%	0.4%	1.3%	78.4%	19.8%
		Students	0.0%	3.4%	4.8%	48.6%	43.2%
		Total	0.0%	1.6%	2.7%	66.8%	29.0%
V ₈	Scientific designing of confirmation requests	CAs	0.0%	0.0%	4.8%	85.5%	9.7%
		Students	0.0%	4.1%	4.1%	54.1%	37.7%
		Total	0.0%	1.6%	4.6%	73.2%	20.6%
V ₉	Applying alternative method of getting confirmation if the parties are in legal dispute	CAs	0.4%	5.7%	3.5%	79.7%	10.6%
		Students	0.7%	4.8%	4.1%	63.0%	27.4%
		Total	0.5%	5.4%	3.8%	73.2%	17.2%
V ₁₀	Necessity of confirmation for accounts receivable and accounts payable balance only	CAs	0.0%	19.4%	4.4%	70.9%	5.3%
		Students	6.2%	21.2%	7.5%	43.8%	21.2%
		Total	2.4%	20.1%	5.6%	60.3%	11.5%
V ₁₁	Statutory auditors' responsibility even if he is relying on the work of auditor's expert	CAs	0.00%	10.60%	6.20%	78.00%	5.30%
		Students	4.10%	11.00%	5.50%	54.80%	24.70%
		Total	1.60%	10.70%	5.90%	68.90%	12.90%
V ₁₂	Evaluation of competence and independence of auditor's expert	CAs	0.40%	13.20%	4.00%	73.10%	9.30%
		Students	2.70%	4.80%	5.50%	49.30%	37.70%
		Total	1.30%	9.90%	4.60%	63.80%	20.40%

Source: Compilation of Field Survey Data using SPSS 20.0

FINDINGS

- Statutory auditors should mandatorily check internal control system of the company.
- Statutory auditors' dependence on internal audit impairs audit quality.
- Excessive reliance placed on internal auditors' work ultimately impairs quality of audit.
- A wide range of CAs and Students have call for testing competence and integrity of internal auditor. They have also shown their support for strengthening Audit Committee.
- The greatest proportion of both these groups also advocates for a thorough checking of internal auditors' report on risk of material misstatement.
- Standards governing internal audit operation in a country are not properly enforced.
- Scientific designing of confirmation request would help an auditor to gather reliable evidence.
- If the client and 3rd party are in a legal dispute, auditors should apply alternative methods of gathering evidences instead of going for 3rd party confirmation.
- External confirmation is necessary only confirming accounts receivable and accounts payable balance.
- Majority of CAs and Students do not undermine the responsibility of statutory auditors even if he is relying on the work of auditor's expert.
- Competence and independence of an auditor's expert should be properly evaluated.

IDENTIFYING THE IMPORTANCE ASSOCIATED WITH EACH VARIABLE GOVERNING QUALITY OF STATUTORY FINANCIAL AUDIT

In order to know the cumulative views of individual respondent groups and the final sample for a particular variable, scores have been assigned to each agreement level. Accordingly, a score of 5 is assigned to 'SA'; score of 4 is assigned to 'A'; score of 3 is assigned to 'N'; score of 2 is assigned to 'D'; and score of 1 is assigned to 'SD'. When a respondent marks his agreement with a particular variable in any one of these 5 levels, its corresponding score is assigned to him. Accordingly, cumulative score of all the respondents in a group or the final sample can be calculated for a particular variable. The average or mean score represents the cumulative views of the final sample or individual respondent groups on a particular variable. As individual score rises with the rise in level of agreement, more the mean score, more is the degree of agreement with a particular variable. As score 3 represent neutral behaviour, if mean score for a particular variable is more than 3, it can be concluded that respondent groups or the final sample assigns more importance to that variable and vice versa. In this segment, mean score of each independent variable for individual respondent groups and the final sample is calculated as follows:

TABLE 4: MEAN SCORE OF INDIVIDUAL OCCUPATIONAL CATEGORIES AND FINAL SAMPLE

Variable Code	Variable	Mean Score		
		CAs	Students	Total
V ₁	Mandatory checking of internal control system by statutory auditors	4.176211	4.315068	4.230563
V ₂	Statutory auditors' dependence on internal auditor	3.559471	3.054795	3.36193
V ₃	Excessive reliance placed on internal auditors' work	4.008811	3.965753	3.991957
V ₄	Testing competence and integrity of internal auditor	3.46696	4.061644	3.699732
V ₅	Strengthening Audit Committee	4.035242	4.178082	4.091153
V ₆	Thorough checking of internal auditors' report on risk of material misstatement	4.105727	4.143836	4.120643
V ₇	Lack of enforceability of standards governing internal audit operations	3.30837	3.568493	3.410188
V ₈	Scientific designing of confirmation requests	4.048458	4.253425	4.128686
V ₉	Applying alternative method of getting confirmation if the parties are in legal dispute	3.942731	4.116438	4.010724
V ₁₀	Necessity of confirmation for accounts receivable and accounts payable balance only	3.621145	3.527397	3.58445
V ₁₁	Statutory auditors' responsibility even if he is relying on the work of auditor's expert	3.779736	3.849315	3.806971
V ₁₂	Evaluation of competence and independence of auditor's expert	3.77533	4.143836	3.919571

Source: Compilation of Field Survey Data using SPSS 20.0

FINDINGS

- According to the CAs, 'Mandatory checking of internal control system by statutory auditors' (V₁) is the most important variable governing quality of audit followed by 'Scientific designing of confirmation requests' (V₈), 'Thorough checking of internal auditors' report on risk of material misstatement' (V₆), and 'Strengthening Audit Committee' (V₅).
- CAs do not assign much importance to 'Scientific designing of confirmation requests' (V₈), while they believe 'Excessive reliance placed on internal auditors' work' (V₃) is an important issue governing audit procedure.
- Students on the other hand have shown similar views as that of the overall sample.

CONCLUSIONS

Internal control mechanism of the client company, external third parties, and auditors' expert have considerable influence on quality of statutory financial audit in a company. There has been a public disquiet about effectiveness of these issues in actual audit procedures after the occurrence of recent corporate frauds. Opinions of CAs and Students on these issues suggest that statutory auditors should mandatorily check internal control mechanism in the company. They should examine the competence and independence of internal auditors and auditors' expert. However, they should not completely depend upon their work. A strong Audit Committee is also considered to be important by the participating respondents. Respondents also affirm that auditors need external confirmation mainly for accounts receivable and payable balance. Hence, scientific designing of confirmation request is necessary. However, any dispute between the client and external third should be properly investigated before getting the confirmation from them. The overall analysis suggests that existing regulations governing role of internal auditors, external third party and auditors' expert are sufficient. However, a proper enforcement of those regulations is necessary to enhance the quality of statutory financial audit.

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