

THE IMPROVEMENT OF AUDIT QUALITY CONTROL SYSTEM

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Kew words: audit quality control system; audit of financial statements; auditor's report; external audit quality control; audit firm; independent auditor; internal quality control for audits; international standards for audit; independence; national standards for audit; related services.

The article describes the system of audit quality control, which exists in Russia today, taking into consideration recent changes. It analyses possible improvements of internal and external quality control for audits with regards to Russian and international experience, as well as improvement of audit quality from the perspective of administrative and economic regulatory mechanisms of audit procedures.

The main role of auditing today is to evaluate of the accuracy of financial statements of business units. The importance of this role is really difficult to overestimate in today's economy. We can mention the row over corporate scandals in the USA and EC of 2002-2004, which caused economic damage to capital markets in particular and global economy in general. As a result, people stopped trusting the audit institution and measures to improve the credibility of audited financial statements have become a big issue. From one point, these measures were to strengthen corporate governance and improve the institute of risk management, and, from another point, to enhance auditing quality¹.

Unfortunately, in Russia the practice of so-called "black" and "grey" auditing is still pretty common. In the case of the "black" one the auditor gives a favourable auditor's report without any auditing. By a "grey" audit we understand a situation when auditing is conducted; some suggestions for accounting and record-keeping improvement are probably made, but even if the book-keeping report is not complete, the company gets a favorable auditor's report anyway². The cases of "grey" audit are those, which were an issue in the above-mentioned scandals. Due to section 11 of Federal Law of Russia ("About auditing activities"), both cases are valued as "deliberately false auditor's report", while in the western countries the term "to buy auditing opinion" is used. Legal auditing differs from "black" and "grey" ones. Normally, a company gets an auditor's report based on the financial statements, and there are adverse auditor's reports if the financial statements are not accurate.

The improvement of the quality of auditing activity is of vital importance for economics today. One of the main regulating elements for audit activity is audit quality control.

The lack of conceptual framework development is the main problem in improving audit quality in Russia today, the experts say³.

Recently elaborated legal documents, based on international analogues, are very important for the improvement of audit services quality, but this is not enough. Besides, the amendments to the Federal Law "About audit activities" have slowed down.

The system of audit quality control includes internal and external control. In accordance with the Federal law "About audit activities", audit firms and independent auditors are to set and follow certain rules for internal control for the audit activity. Requirements to these rules are regulated by Federal Auditing Standards.

Following the standard requirements is not the only objective of internal quality control for auditing. We consider the achievement of high quality auditing services, which meet client requirements, to be of high importance.

The corporate scandals at the beginning of this century were followed by the IFAC (International Federation of Accountants) decision to change the international standards for audits. Thus, new requirements to the system of internal quality control for audits were established. These changes are registered in the new standards, which operate from 15 June 2005: ISA 220R "Quality Control for Audits of Historical Financial Information" and ISQC 1 "Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and other Assurance and Related Services Engagements"⁴.

In August 2008 Federal Audit Activity Regulation (standard) #34 "The quality control of services in audit firms" (Government Standard for Audit (FPSAD) #34) came into effect. It coincides with ISQS 1. Today the new project of Federal Activity

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Regulation (standard) №7 “The quality control for audit work”, which coincides with ISA 220R, is being discussed.

Due to the requirements of ISQS 1 and Government Standard for Audit (FPSAD) №34 an auditing firm is to have a quality control system to make sure that the firm itself and that the employees meet all the standards, follow the regulations and legal requirements, and the auditor’s report reflects the real situation. There are certain requirements to the structure of the internal control system of the firm, which are regulated by the audit standards.

ISA 220R and Government Standard for Audit (FPSAD) №7 contain regulations for the quality control of a certain audit engagement, including the following: the company’s managing staff is responsible for the quality of audit engagements, the firm is to stay in contact with the client, the audit engagement agreement is needed, the auditor’s are to follow ethical principles in their job.

In June, 2008 the “Internal audit control methodological recommendations” were published. It is an instruction how to organize the system of internal audit control and make it function effectively. This document is a practical recommendation to concerned parties about the requirements, registered in Government Standard for Audit (FPSAD) №7.

A better organization of internal firm control, accurate auditing, and sharing experience will enhance the quality of auditing services in Russia. But yet, internal control does not only improve legal auditing quality, but also gives a way for the so-called “grey” audit development, in cases when there is no financial statement fraud, which the auditor does not include into report intentionally, E. M. Gutzeit says⁵. It does not provide any possibilities for “black” audit to develop.

The external quality control system (control by external auditors) is regulated by the Ministry of Finance of Russia. External auditing can be either held by the Ministry of Finance, or accredited auditing companies can perform this function.

The subject of external control for auditing today is the supervision of how audit companies and independent auditors comply with the requirements, regulated in the Federal Law “About audit activities”, other legal acts, Government Standards for Audit and Auditor Code of Ethics.

Speaking about the goal of external quality control for auditing in Russia, we agree with E. M.

Gutzeit, who defines it as a necessity to banish all the laymen and frauds from the audit service market, and to enhance the quality of the service, provided by others⁶.

The system of external control for auditing is regulated today by temporary methodological recommendations and the auditing of services quality control. The auditors are the companies, accredited by the Ministry of Finance and approved by the Audit Council.

The external control for auditing activities is aimed mainly at supervising of service quality and following of ethical principles. The control over audit related services is not so strict, because they are not so popular and the customers are pretty qualified.

The Audit Committee of the Board of Directors control of united independent auditing firms is sometimes also considered to be a procedure of external quality control for audit.

Certification and licensing are the two elements of audit activity control which, in our opinion, belong to preliminary audit. There are a lot of debates about the existing system of auditors certification and audit activities licensing, and the methods for its improvement.

The Department for Regulation of Financial control, audit activities, business accounting and the Ministry of Finance accounting single out the following problems in the system of external quality control for auditing in 2007:

- 1) audit firms and independent auditors lack stimulus for passing external service quality control procedures;
- 2) external quality control lacks coordination;
- 3) auditors need to improve skills;
- 4) the results of external quality control lack publicity.

The Audit Council members were concerned about managing the mentioned-above problems and they gave several recommendations:

1. To improve the external services quality control planning, including clear criteria for selection of the companies to inspect. There is a tendency to first of all inspect the audit firms and independent auditors, which control the accounting of public companies. Such companies’ accounting is considered reliable and it plays a very important role in the financial system stability.

2. To obligate each audit firm to pass external auditing services quality control at least once every 3 years. Today it is not regulated by any law.

These measures, to our mind, can help to prevent the cases of "black" audit.

3. To arrange skill improvement for external services quality control auditors. The external services quality control is a new practice and it is important to analyze organizational, methodological and methodical aspects of work and to pay special attention to control independence and confidentiality of information. It should also be mentioned that auditors should show the right way to manage business; therefore they should be paid properly.

4. To publish reports on the external quality control system in audit firms annually. This will provide more information about the whole system and improve reliability of auditing. In our opinion, the Federal Agency for Audit Regulating will also find information, containing the number of audited companies, favorable reports, and suspected "black" audit firms, helpful, when making decisions. It should be mentioned that the delegation of control functions is inevitable today, even though some specialists doubt the effectiveness of external quality control by audit firm and the independence of such control. So, we consider it vital for the Ministry of Finance to be able to withdraw the license of any audit firm if the regulated rules are violated. This will provide additional control from the Ministry of Finance in case of unexpected circumstances (such as complaints, etc.).

International experience of audit activity regulating shows, that it is important to provide a high degree of auditors independence. It can be achieved by:

1. Limiting the profit share of each client in the annual profit of audit company.

2. Enlarging the list of services in the Federal law "About audit activities", which are incompatible with auditing, by including new separate ones, like evaluation, finance security system installation, accurate accounting, outsourcing of internal audit, legal and other services. The question of forming an audit committee in public companies is also under consideration. It is a common practice in the USA (due to Sarbanes-Oxley Act) and countries of European Union (due to the 8th EU Directive). The committee is to be responsible for the appointment of an auditor for the engagement and the license for provision of additional services if the company is audited by one and the same firm.

3. Requiring the rotation of the audit firm partner (the person, responsible for task performance)

not less than once in 5 years. This minimizes the risk of abusive practice or auditor's mistakes.

The administrative regulation mechanism dominates in Russia today. Licensing, license withdrawal, audit activity certification, certificates withdrawal, auditing standards, etc. belong to this mechanism. Some specialists say that the economical regulation mechanism can improve the quality of auditing services⁷. Fines for inappropriate auditing, insurance of public liability for auditors, the system of audit firms rating, etc. belong to this mechanism.

Fines for inappropriate auditing can be very efficient, but they come to effect only after the damage has been done. In this case it is vital for any individual person or legal body to have a right to appeal to court. The division of financial responsibility between the company, which has inaccurate financial statements, and the audit firm, which gave a favorable report to such company, still needs to be analyzed and discussed. Due to the Federal Law "About audit activities", the auditing firm must insure the risk of breach of contract. So, it can be profitable to establish a starting rate of compulsory insurance and franchise (for public companies, at least). We consider the following idea quite interesting: the insurance company gets money from the customer and takes out an insurance contract, should pay the audit firm.

The mechanism of audit firms rating is also a stimulus for service quality improvement.

A combination of internal quality control for audits and administrative and economic regulations of external quality control for audits will improve the service and its reliability in our country.

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² *Gutzeit E. M.* Modern audit control alternatives // Journal of auditing. 2008. № 7.

³ *Chaja V. T.* The quality of audit: questions and answers // International Standards for financial statements in credit companies. 2006. №5.

⁴ Handbook of International Auditing, Assurance, and Ethics Pronouncements. - 2008 Edition, New York: IFAC, 2008. (www.ifac.org).

⁵ *Gutzeit E. M.* External Quality control for audit // journal of auditing. 2004. #4

⁶ *Gutzeit E. M.* External Quality control for audit // journal of auditing. 2004. № 4.

⁷ *Golosov O. V., Gutzeit E. M.* Audit: conception, problems, standards, control, effectiveness, crisis. M., 2005.