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Discussant's Response to The Case for the Unstructured Audit Approach

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I would like to begin by making a few general comments concerning Jerry's paper. I found the paper somewhat unstructured, which supports the use of the title, and I found no new quantitative evidence in the paper supporting the unstructured approach, although the paper does cite support from the Hylas-Ashton study. Interestingly, however, this study was based upon the practice of Peat, Marwick, Mitchell & Co., a firm which most would classify as highly structured.

I plan to structure the remainder of my comments in three main areas: (1) areas of agreement, (2) points of concern, and (3) questions in need of further elaboration.

Areas of Agreement

Jerry makes several statements in the paper which I would defy anyone to disagree with. For example, no one could possibly argue with the following points:

Audit firms should perform effective, efficient audits.

Auditors need to integrate knowledge obtained throughout the audit process.

However, such statements add little to either the academic or practitioner literature and provide no new insights.

Points of Concern

My primary point of concern is that Jerry has set up a straw man (or straw person if you wish) which he easily attacks and dismisses as an inappropriate audit approach. This straw man is, of course, the structured audit approach. For example, Jerry suggests that a structured approach is likely to involve a series of seven policies*. However, few practitioners or academicians would endorse any of these policies. Consequently, it is not surprising that Jerry arrives at the conclusion that the structured approach is an inappropriate audit approach. To illustrate, I have briefly analyzed each of these policies below:

1. All potential new clients would be investigated to the same extent.

* Jerry indicates that the seven policies used to define a structured audit approach were adapted from the Cushing and Loebbecke study on audit methodologies. The final version of this study was unavailable as of the symposium date. Irrespective of their source, the point remains that the seven policies are so restrictive as to be meaningless in comparing a structured approach with an unstructured approach.

I know of no firms which would endorse such a policy. As clients differ in business risk and audit risk so too would the extent of pre-audit investigations. Perhaps Jerry had in mind that all new clients would be investigated to some minimum extent. Most academicians and practitioners would agree with such a statement.

2. All audit areas would be audited at a certain standard level of effort.

   Again, I know of no firms which would endorse such a policy. As audit areas differ by risk levels, so would the extent of work. In addition, the optimal level of auditing for any given area would also depend upon the cost of auditing the area. For example, cash is often audited to a relatively low level of tolerable error simply because the cost is not high. Perhaps Jerry had in mind some minimum level of auditing for each area.

3. A totally substantive approach to an audit or to one audit area would not be possible, and some detailed compliance tests would always be required

   Again, I know of no firms which would endorse such a policy. Compliance tests are frequently not conducted in many areas of the audit.

4. If the auditor wished to rely on internal control for one audit objective for one type of transaction, internal control would have to be relied on to meet all audit objectives for all types of transactions and related accounts.

   This statement is so extreme so as to be nonsense.

5. Statistical sampling would be used for all detailed tests.

   Again, this statement is simply nonsense.

6. Materiality would be allocated to various audit areas using a statistical algorithm that totally ignored qualitative considerations.

   This statement has some merit. Materiality should be allocated across audit areas consistent with the philosophy of SAS 47; however, depending upon how one defines qualitative considerations, such factors could be considered. In addition, one should also recognize that how the auditor considers materiality allocation depends upon the auditor's sampling approach. For example, dollar unit samplers can be said to consider materiality allocation in a broad sense when they establish the tolerable error for their samples.

7. Inherent risk would not enter into the determination of the scope of audit procedures at all—that is, inherent risk would be set at 100 percent—presumably because the evaluation and assessment of inherent risk are not susceptible to quantitative determination.

   I personally believe that it is in the best interests of the profession if auditors would adhere to this policy. However, SAS 47 clearly recognizes that inherent risk may be relied upon and set at less than 100 percent. Given the competitive environment of public accounting, I seriously doubt if any firm, structured or unstructured, would adopt this policy.

The above analysis suggests that 6 out of the 7 policies which Jerry attributes to a structured approach are at best unrealistic and at worst misleading.

Early in the paper Jerry complains about the use of the terms "structured" and "unstructured" and suggests that the term unstructured carries a negative stigma, whereas the structured approach does not allow or minimizes auditor judgment. Clearly, regardless of what audit approach is followed, the nature of auditing requires professional judgment. Jerry has apparently missed the essence of a structured approach. Specifically, firms employing structured approaches attempt to develop heuristics (or rules of thumb) to enhance the auditor's judgment process—not to reduce or eliminate the role of judgment.

Jerry also takes pains to point out that the structured approach would lead to inefficient auditing. However, this analysis is in many ways irrelevant because it is based upon the straw man that was set up early in the paper. For example, an audit approach that requires compliance testing in all areas will clearly be inefficient. In addition, the difficulty of relating internal accounting controls to substantive testing is a concern of both the structured and unstructured approaches. Finally, if structured firms were as inefficient as Jerry suggests, then there should be a shift in the market share away from the less efficient structured firms to the unstructured firms, if for no other reason than because the unstructured firms could offer their audits at a lower cost. However, examination of recent changes in auditors among public companies indicate that structured firms seem to be doing as well as unstructured firms in obtaining new clients.

Questions in Need of Elaboration

In general I found the information content of Jerry's paper small. I would have liked to have seen Jerry expand upon some of the unique aspects of what he believes is the Coopers & Lybrand audit approach. For example, the reperformance of control procedures is a standard practice for many firms. As a matter of fact, this is a policy of many structured firms. In addition, the distinction between disciplinary and basic controls and how C&L uses this distinction in their audit approach was not clear. Jerry's example of accounts receivable confirmations was confusing to me. If the audit objective is existence of the account, I don't understand how the auditor could be satisfied through reliance on supervisory controls and the functioning of the shipping and billing functions.

Concluding Remarks

Perhaps the real issue that this paper brings to light is: "What is an effective, efficient audit?" Conceptually, we can address this question (see SAS 47), but on a practical basis we have no way of measuring the product of the audit process. This product can be conceptually stated as the likelihood that material errors exist in the financial statements reported upon. Thus, we have the debate about a structured versus unstructured approach, the usefulness of compliance testing, etc. Until we devise a measure of audit quality, little real progress will be made on determining the properties of a normative audit.