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Discussant's response to audit detection of financial statement errors

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The recent competition among public accounting firms for clients has forced them to find more efficient ways to conduct audits. The methods chosen to improve efficiency, however, must be as effective as the old methods in detecting error or auditors must be willing to accept higher levels of risk on their engagements. The results reported in Hylas' paper (and which are based on the study by Hylas and Ashton[1]) provide many insights for practitioners and present some interesting areas of research for academicians. In particular, this study provides valuable information on how auditors can more efficiently *and* effectively conduct audits.

In my discussion I will first address some specific areas of the study that are particularly interesting and informative. Secondly, I would like to comment on Hylas' scenario for an effective and efficient audit.

Specific Areas of Interest

In this section I would first like to address two specific results that may have a significant impact on the way audits are presently conducted. I will folow this with a subsection which contains a number of miscellaneous comments.

Personnel Related Problems

The result that surprised me the most was that the auditors who participated in the study "attributed a great many errors to various personnel problems, including employee turnover and inexperience, time pressure, carelessness, and even incompetence." Relatedly, a large number of errors resulted from a lack of accounting knowledge by client personnel. There are some serious implications for accounting control from such findings. SAS Section 320.30-.48 outlines the basic concepts or elements of internal control. Of all the concepts listed in those standards, the most critical element to the internal control system is competent and trustworthy personnel. This results from the fact that even if all of the other concepts of internal control (e.g. segregation of duties, execution and recording of transactions, etc.) are present, incompetent personnel can destroy their effectiveness.

Does the fact that a large percentage of errors are caused by personnel problems pose difficulties for the auditor? My inclination is that it does. This is based on the belief that it is difficult for auditors to assess personnel related problems *ex ante* (i.e. early in the audit). Certainly, employee turnover and inexperience should be "red flags" to the auditor, but judging the competence

of client personnel may be very difficult. In fact, auditors may only get a "feel" for this *after* performing tests of transactions. Of course, prior experience with the client may help.

While I have not surveyed any public accounting firms, I suspect that auditors currently do not make "formal" assessments of client personnel. Given the results of this study, auditors should consider refining their approaches to personnel evaluation and/or develop new ways of identifying "problem" personnel early in the audit and allocate audit resources in their areas of responsibility.

Analytical Review Procedures

The result that analytical review procedures (ARPs) identified a high percentage of errors should be very encouraging to auditors because it provides empirical support for current auditing standards (SAS Section 318). These results are also encouraging because these procedures appear to be as effective as tests of details in detecting errors and probably can be conducted at a lower cost. I assume from reading the paper that the ARPs reported on did not include formal quantitative approaches such as regression analysis which may be more costly.

I have two comments about this result that require clarification. First, we normally think of ARPs as being useful in detecting unusual fluctuations. The implication to me is that this means "large errors." The results of the study indicates that ARPs were equally effective at finding "small errors." My concern here is why auditors would be investigating fluctuations that result in "small errors." The only explanation that appears reasonable was that these "small" errors were still material. Further research along these lines (i.e. investigation rules) would be helpful.[2]

Secondly, the study provides no information on the state of the sample companies' internal control systems. Kinney has pointed out that "The marginal effectiveness of preliminary analytical review in predicting error depends in part upon the effectiveness of internal control subsystems . . ."[3] In the current study we have no way of determining whether ARPs were effective in and of themselves or because the auditors knew of internal control weaknesses from prior experience and therefore knew where to suspect errors. Future studies of this type need to examine the evaluation of internal control on the effectiveness of ARPs.

I think the findings that ARPs and other informal procedures were effective in detecting errors is important for another reason that was given only casual comment in the paper. This relates to the use of ARPs for reviews of financial statements for non-public companies. The main procedures required by Statement on Standards for Accounting and Review Services No. 1 for a review engagement are inquiry and ARPs. My discussions with individuals from both large and small public accounting firms indicate that there is a great deal of diversity in how firms approach review engagements. I have been told by a number of CPAs that the type and amount of evidence gathered on review engagements often approaches the amount gathered on an audit (e.g. confirmations of accounts receivable, vouching of selected accounts, etc.). These same CPAs indicate that one of the reasons this occurs is that they are just not satisfied with the effectiveness of inquiry and ARPs. The results reported in

this paper should relieve some of their fears in relying on these evidence gathering procedures.

Miscellaneous Comments

The study contained a number of other findings that are worth mentioning. First, is the result that a small percentage (4%) of errors were intentional. This is noteworthy but we must be very careful not to place too much reliance on such a result. If the client or client personnel have "strategically manipulated" accounting information, traditional audit procedures may not be effective in finding them.[4]

Second, is the result "that externally-prepared documentation is no more likely to be a source for detecting errors than internally-prepared documentation." This result would be more meaningful if we knew what percentage of total documentary evidence was in each category. For example, if 80% of the documentary evidence that auditors examine on an engagement is internal, then we would expect internally-prepared documents to detect a high percentage of errors. In other words, I am suggesting we not dispose of the idea that external evidence is more reliable until we have more data.

A Revised Audit Scenario

Hylas' scenario for an effective and efficient audit is somewhat different from what auditors are currently doing, although I think competitive pressures are pushing them in that direction. I agree with him that auditors should allocate their resources where they *expect* errors. There are two points in the audit process where such an approach will prove most beneficial: (1) where auditors use ARPs early in an engagement for planning purposes and (2) in the study and evaluation of internal control. In the first instance the auditor will have to identify unusual fluctuations and then allocate resources to investigate their causes. In the second instance the auditor must "anticipate" what types of errors can result from a particular control weakness before allocating audit resources. Unfortunately, we have little evidence on how well auditors perform these tasks.[5]

A second comment on Hylas' scenario concerns the audit work at the test of details stage. He suggests that tests of details should be "applied extensively only where errors are considered a distinct possibility." If we assume that auditors are able to anticipate errors, then the current approach of taking large random samples could be modified. If auditors design audit procedures to assess the effect of *specific* types of errors then there is no need to take large random samples. At this point auditors would only be interested in the presence of "unanticipated" types of errors. In such instances some type of discovery sampling might be more appropriate.[6]

Conclusion

I view auditing as an evolutionary process where audit firms must adapt to a changing environment. Studies like Hylas and Ashton's provide valuable information which can assist audit firms in this adaptation process. I hope that the future will see further collaboration between practitioners and academics in studies similar to the one discussed today.

Footnotes

1. Hylas, R.E. and R.H. Ashton, "Audit Detection of Financial Statement Errors" *The Accounting Review* (forthcoming).

2. See W.R. Kinney, Jr. and G.L. Salamon, "Regression Analysis in Auditing: A Comparison of Alternative Investigation Rules" *Journal of Accounting Research* (forthcoming) for an example of such research.

3. W.R. Kinney Jr., "The Predictive Power of Limited Information in Preliminary Analytical Review: An Empirical Study" *Studies on Auditing-Selection from the "Research Opportunities in Auditing" Program*, Supplement to *Journal of Accounting Research* (1979), p. 151.

4. Studies by A.R. Sumutka, "Questionable Payments and Practices: Why? How? Detection? Prevention?" *Journal of Accountancy* (March 1980), pp. 50-64 and M.E. Romney, W.S. Albrecht and D.J. Cherrington, "Auditors and the Detection of Fraud" *Journal of Accountancy* (May 1980), pp. 63-69 indicate that traditional audit procedures are not very effective in detecting intentional actions by management or client personnel.

5. See W.F. Messier, Jr. and R.D. Plumlee, "Auditor Evaluation of Error Type and Frequency: Some Preliminary Results," working paper, University of Florida, July 1982, for some preliminary results on auditors' ability to anticipate errors resulting from internal control weaknesses.

6. See S. Moriarity, "Discussion of Decision Theory Aspects of Internal Control System Design/Compliance and Substantive Tests" *Studies on Statistical Methodology in Auditing*, Supplement to *Journal of Accounting Research* (1975) pp. 30-34. for a further discussion on a discovery sampling approach.