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Case for the structured audit

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This paper provides: 1) a definition and illustration of a structured audit; 2) a comparison to other types of audit approaches; 3) some analysis of the audit environment including a segmentation of the different levels of audit activity; and 4) comparisons of the different types of audit approaches within the broad categories of audit activity.

What is a Structured Audit?

As this term is not common, it may be useful to see how it was derived. A dictionary definition of "structure" provides the following elements:

- A meaningful frame of reference
- An established relationship between components
- A set of rules or an agenda to be followed
- An arrangement in a definite pattern of organization.

Therefore, a structured audit would be one with a meaningful frame of reference, with different areas of the audit clearly related to one another, with a predetermined way of proceeding, and with a definite pattern of organization.

An Example of the Structured Approach

The Touche Ross Audit Process is an example of a structured audit approach in that it is based on a conceptual framework that is used to design a program for each specific audit engagement. Our process enables us to focus our audit effort—and get results—where audit risks and significance are greatest. It is based on two major assumptions, namely:

- No two audits are so similar that major differences will not have to be dealt with
- Risk assessment and a focus on the entity's transactions provide an organizational framework that can be applied across all audits.

The process is neither overly rigid nor lacking in direction and thrust—it provides a disciplined approach based on risk assessment to determine audit effort. Recognizing that no two companies are identical, the process focuses on the company's transactions, a focus that unifies the audit effort as it does the company's operations. It works this way: first, we understand the company's business because that understanding is vital to a focused audit. Second, we understand the company's operating transactions because these are the tangible evidence of business activity and the unifying ingredient in every company's internal accounting control systems. This understanding is then focused (a) on the potential errors in transactions or their recording for the period under audit and (b) on judgments about probable future transactions and their effect on the financial information being reported.

The process is performed, as illustrated in Figure 1, in three phases:

- Phase I, Planning and Evaluation: Where should audit attention be concentrated and how shall we satisfy our audit objectives? That depends, of course, on what the company does, its location, size, control systems, and many other matters. Using our knowledge of the industry, we broadly consider information about the client's business, identify areas of significance and risk, document major accounting systems, begin evaluation of internal control, and develop the overall audit plan.
- Phase II, Testing: If our reliance on internal control will be significant, we test and evaluate the system. This is an efficiency and effectiveness decision based on the apparent reliability of the system. Ordinarily, the larger the company, the more significant is the need for a well-developed control system that sorts and processes its vast number of transactions. The smaller the company, the more necessary it becomes, usually, to test transactions and balances themselves rather than the control system. In either case, both kinds of tests are significant. The process uses both approaches to transaction testing, as appropriate, to achieve our integrated, specific audit objectives.
- Phase III, Completion of the Audit: The nature and extent of the work required depends on our assessment of the likelihood of errors in the financial statements, together with our conclusions from Phases I and II of the audit. The procedures, all of which are correlated with specific audit objectives, are analytical and detailed.

Other Types of Audit Approaches and Their Basis

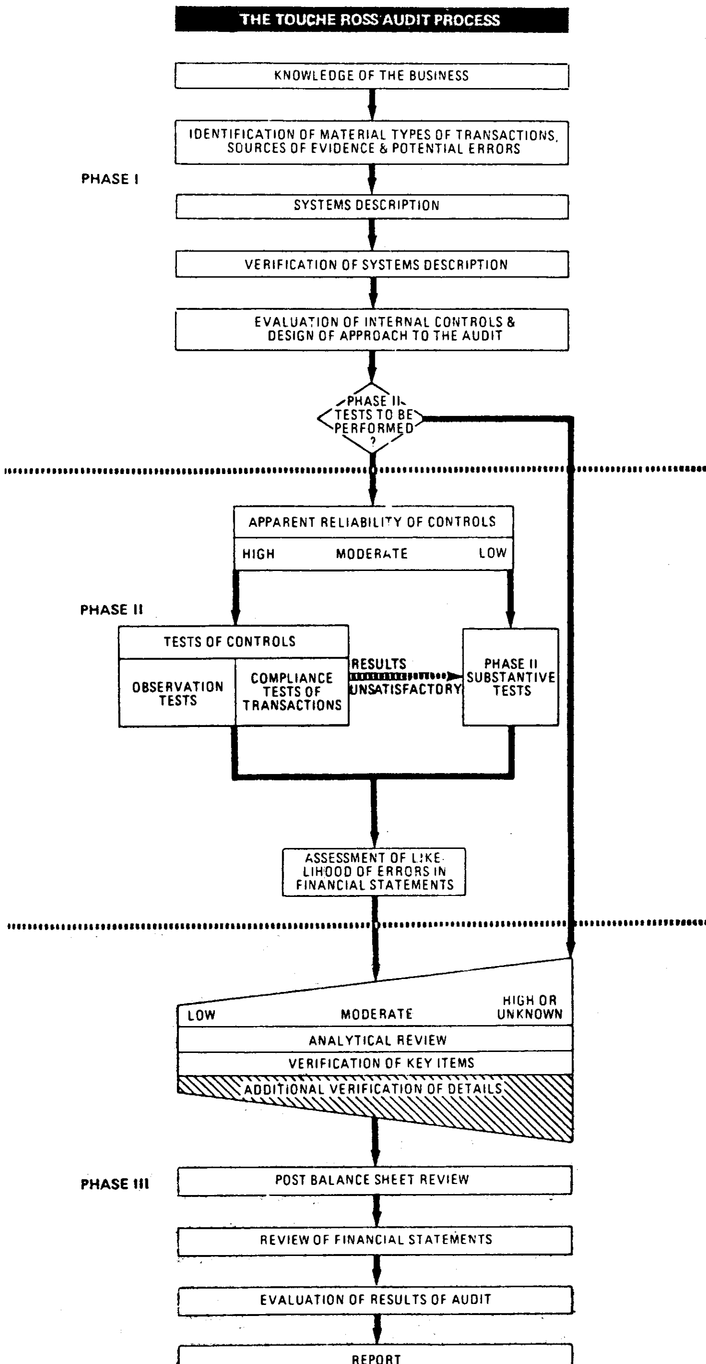
Two other basic types exist, namely:

- *Unique approach*—each audit is so different that a generalized approach is not possible, and each audit must be individually designed.
- *Predesigned approach*—all audits are so similar that a specific approach can be designed for all parts of the audit.

The "unique" approach is based either on the assumption that each audit is so different that it must be designed without use of a general approach or structure, or that use of a general approach is not cost effective. This approach places a particular burden on the planner of the audit to use the full measure of audit knowledge and experience in each engagement. It requires the audit planner to be a seasoned and knowledgeable audit professional with a particularly good grasp of audit techniques and interrelationships. More than likely, it requires a management group professional (supervisor, manager, or partner) as the planner.

The "predesigned" approach is based on the assumption that all audits, or at least a very large part of all audits (say 80-90 percent), have so many similarities that a predesigned approach (with modest tailoring) is effective. Naturally a number of predesigned approaches can be developed. This

FIGURE 1


THE TOUCHE ROSS AUDIT PROCESS
PHASE I
KNOWLEDGE OF THE BUSINESS
IDENTIFICATION OF MATERIAL TYPES OF TRANSACTIONS, SOURCES OF EVIDENCE & POTENTIAL ERRORS
SYSTEMS DESCRIPTION
VERIFICATION OF SYSTEMS DESCRIPTION
EVALUATION OF INTERNAL CONTROLS & DESIGN OF APPROACH TO THE AUDIT
PHASE II TESTS TO BE PERFORMED ?
PHASE II
APPARENT RELIABILITY OF CONTROLS
HIGH
MODERATE
LOW
TESTS OF CONTROLS
OBSERVATION TESTS
COMPLIANCE TESTS OF TRANSACTIONS
RESULTS UNSATISFACTORY
PHASE II SUBSTANTIVE TESTS
ASSESSMENT OF LIKELIHOOD OF ERRORS IN FINANCIAL STATEMENTS
PHASE III
LOW
MODERATE
HIGH OR UNKNOWN
ANALYTICAL REVIEW
VERIFICATION OF KEY ITEMS
ADDITIONAL VERIFICATION OF DETAILS
POST BALANCE SHEET REVIEW
REVIEW OF FINANCIAL STATEMENTS
EVALUATION OF RESULTS OF AUDIT
REPORT

approach requires more than a recognition that different industries may require different approaches—it would also have to address such issues as whether the audit would be conducted substantially at year end or would involve significant work at an interim date.

Another possible assumption that may support the "predesigned" approach could be characterized as the work-level assumption. Simply put, there would be a tradeoff between investing more experienced audit team members in the planning of a specific audit and requiring far more work than necessary to achieve the audit objective.

Auditing Today and Tomorrow

While each approach in the abstract can be argued to be best, auditing is not performed in the abstract. Before comparisons can be made, we must look at the audit environment as it is today and as it may become.

Auditing today is much more competitive than it was not too long ago. Consequently, some emphasis must be placed on how audit objectives can be achieved in a cost-beneficial way. Additionally, retaining good auditors is becoming a real concern of the public accounting profession because audit experience continues to be an excellent background for financial and management positions in the private and public sector. This situation requires a recognition of the nature and level of work performed by our audit staff as to whether it is challenging, pertinent, and builds useful skills. As well, the mid-1980s are a period of rapid, significant change and unprecedented challenge. Whole sectors of our economy and those of other countries are undergoing profound restructuring. As an example, the U.S. has moved from essentially a manufacturing-based to a service-based economy; moreover, some of our most stable sectors are now much more fluid (e.g., the whole financial services sector). All these factors relate to an assessment of competitive approaches to designing and executing audit activities. The assessment should also give serious attention to the services the audit team is expected to provide now and in the next few years.

More specific discussion may help to make these choices more apparent. Auditing is a demanding profession. It encompasses a significant range of activities from specific activities (e.g., determining how many items to test) to complex and subjective procedures (e.g., assessing the adequacy of an accounting estimate). Auditing will become even more demanding as the business community takes on different reporting responsibilities, such as widespread assurances on prospective financial information or on significantly different financial information such as a larger role for human resource accounting information that seems a natural part of the evolution to a service-based economy.

Financial Information Continuum

A useful way to address the audit and choose which of the three audit strategies might be best is to consider the nature of the financial information subject to audit. Financial information can be roughly segmented, as illustrated in Figure 2. Perhaps an illustration would help. Inventory is a simple example and can be segmented in the following manner:

Mostly Factual—how many and what types of inventory items are there? One related audit decision: how many items to count.

Interpretive and Allocation—How should the cost of material and labor be related to each inventory unit? One related audit decision: how consistent is the method used this year to allocate these costs compared with prior years, and does the allocation result in reasonable cost for each inventory item?

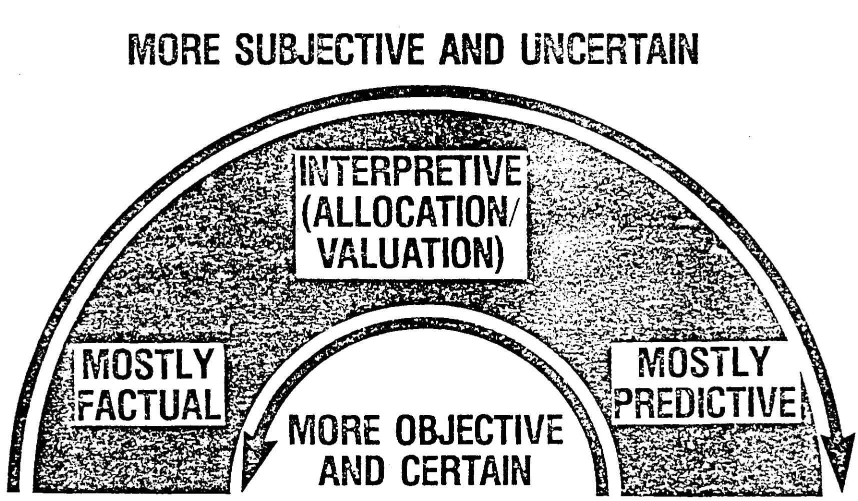
Mostly Predictive—Should the inventory be valued at cost or market? One related audit decision: is the probable sales price of the item greater than cost? If not, what is the probable sales price?

Audit activities should be directly related to who on the audit team will perform them and to the level of their knowledge, skill, and experience base. Also the activities should focus directly on the conclusions that each audit team member can actually make so that those performing the activities have sufficient ability to understand the findings and how they interrelate to other parts of the audit. With this overview of the nature and relative subjectivity of financial information, a broad analysis of audit activities can be made and a consideration of who should perform them discussed.

- *Audit activities associated with the verification of mostly factual information involve staff from the initial to senior category (usually less than four years' experience).* This area usually makes up the largest part of the time spent on each audit. These activities are critical to the audit because they provide the basis on which certain financial statement items are stated. Just as critically, they provide the evidence basis necessary for more skilled and experienced audit team members to challenge other assertions in the financial statements

Figure 2

Financial Information Continuum



that require subjective or more complex judgments, especially those involving consideration of future probabilities.

- *Audit activities associated with the interpretive and allocation aspects of financial information.* These audit activities generally interrelate the audit work on mostly factual data to the financial information presented. Since it is the same basic process as the supervision of the audit field work, it is normally performed by the in-charge person—either a senior or supervisor. Specifically, as related to the financial statements, the activity is directed at determining whether the entity's underlying events and transactions have been presented in the financial information in conformity with generally accepted accounting principles. Related to the audit work, the activity is directed at determining whether all of the underlying audit activities and findings have been correlated to the financial information and have been presented in a manner that will provide a reasonable basis for the audit opinion on the financial information under examination.
- *Audit activities associated with the professional challenge of the more complex, subjective, or predictive judgments that are reflected in financial statement assertions.* This area usually involves audit engagement management using information that has been verified by audit staff together with their own skills, experience, and knowledge as expert auditors and accountants. Though it is not a large part of the time spent on most audits, it is usually the most critical in that it deals with the most significant risks that the financial statements might contain a material misstatement.

How to Assess

The competing audit strategies have been briefly defined and discussed. The nature of the audit has been segmented and discussed to illustrate what is involved and who is involved in terms of staff and in-charge and engagement management. Who should be involved in the performing of the different parts of the audit also has been specified. The balance of this paper attempts to deal with how each audit strategy relates to each of these segments of the audit and the effect on the audit staff.

What Audit Strategy For Mostly Factual Information?

The work associated with the verification of the mostly factual information underlying the audit is performed by the less experienced members of the audit team and is a large part of most audits. This part of the audit involves a number of possible audit approaches, e.g., an audit involving some reliance on internal accounting controls, one involving little reliance on internal accounting controls, or a mix of reliance on some internal accounting controls for some parts of the audit and little reliance in other parts of the audit. This stage also involves a number of generic audit procedures, e.g., compliance and substantive tests with a substantial number of actual procedures that can be used depending on how the entity authorizes, executes, records, and maintains accountability for its resources. The objective of the audit activities here, as with all audit work, is to have an audit plan to "search for errors or irregularities that would have a material effect on the financial statements, and to exercise due skill and care in the conduct of that examination." AICPA

Codification of Statements on Auditing Standards at Section 327.05 goes on to say:

> *The Auditor's Responsibility*
> .05 The independent auditor's objective in making an examination of financial statements in accordance with generally accepted auditing standards is to form an opinion on whether the financial statements present fairly financial position, results of operations, and changes in financial position in conformity with generally accepted accounting principles consistently applied. Consequently, under generally accepted auditing standards the independent auditor has the responsibility, within the inherent limitations of the auditing process. (see paragraphs .11-.13), to plan his examination (see paragraphs .06-.10) to search for errors or irregularities that would have a material effect on the financial statements, and to exercise due skill and care in the conduct of that examination. The auditor's search for material errors or irregularities ordinarily is accomplished by the performance of those auditing procedures that in his judgment are appropriate in the circumstances to form an opinion on the financial statements; extended auditing procedures are required if the auditor's examination indicates that material errors or irregularities may exist (see paragraph .14). An independent auditor's standard report implicitly indicates his belief that the financial statements taken as a whole are not materially misstated as a result of errors or irregularities.

Therefore, it is necessary to determine where such possible risks could exist. Again using inventory as an example, the three approaches could be roughly compared.

For work on a specific account or transaction:

- *Unique Audit.* The planner is a member of engagement management and would know whether inventory has such a risk in it.
- *Structured Audit.* Using a transaction and a risk approach, the significance of inventory is determined, and the specific risk of possible material error or irregularity is assessed (i.e., high, moderate, low).
- *Predesigned Audit.* The specific amount of audit activities subject to some tailoring is designated without specific consideration of risk in this engagement. It would be based on a general consideration of risk in a number of similar engagements.

Relating work on a specific account or balance to other audit work:

- *Unique Audit.* The planner knows how the audit work interrelates and specifies the effect of that interrelationship on other audit work to be performed.
- *Structured Audit.* Transactions tie together most of the major activities of the entity under examination. Therefore, following the transaction from initiation to its final destination enables the relationship to other audit work to be detailed.

The relationships that need to be understood and interrelated in either approach for just a single transaction will indicate the complexity. The normal interrelationships and effects of just a single transaction, assuming that a significant risk could exist, requires consideration that a number of possible things can go wrong with a transaction. For example, some of the things that can go wrong with a sales transaction are:

- Sales can be recorded, but goods are not shipped;
- Goods can be shipped but not recorded;
- Sales can be recorded incorrectly;
- Sales can be improperly costed;
- Sales can be recorded in the wrong period.

To prevent or detect these possible errors, many different controls may appear to exist. A decision has to be made as to which controls—manual or EDP-based—to test in relation to one or more potential errors. Alternatively, controls may not be a significant part of the audit, and substantive tests will not take into the account any reliance on controls (except that necessary to meet the objectives of auditability and controls sufficient to enable substantive audit tests to be performed). Note that some auditing procedures may pertain to more than one potential error, whereas in other cases a combination of auditing procedures and related assurances may be necessary to deal with a single potential error type.

Finally, a single transaction (and related potential errors) will affect at least two financial statement account balances as a consequence of double-entry bookkeeping. In many cases, transaction and related potential errors in one transaction can affect other parts of the transaction stream (e.g., the relationship between the sales system and the costing system). While this formulation takes some license with the audit process—it would need to be substantially expanded to specifically address the decisions that actually need to be made—it does point out the complexity of the interrelationships the auditor must deal with.

- *Predesigned Approach.* All of these relationships can be specified in general statements of audit activities that will require only modest tailoring.

What Audit Strategy For Interpretive and Allocative Aspects of Financial Information?

This part of the audit addresses whether all the underlying events and transactions have been presented in conformity with generally accepted accounting principles in the financial information to be presented prior to the necessary valuation decisions addressed in the next section (mostly the predictive aspects of financial information). As it relates to this level of audit work, it means whether all of the underlying audit activities have been correlated in a manner that provides a reasonable basis for an audit opinion as to whether the financial information under examination represents appropriately authorized, executed, recorded, and summarized transactions and events.

The different approaches in this area are:

- *Unique Audit.* The focus would be on exceptions to the plan, whether they were different than anticipated and how that affects work still to be done or already done. The work is usually arranged in relation to account balances.
- *Structured Audit.* The work performed is arranged in relation to major transactions (initiation to account balance) or balance (interrelated to transaction base). It provides an indication of risks and

considers their significance and how the audit work leads to the specific assessments.

- *Predesigned Approach.* The predesigned approach is modified to consider matters that were different than anticipated. The work is usually arranged in relation to account balances.

The differences are pronounced. Both the unique and the predesigned will usually result in working papers that relate audit findings to account balances and separate the work done to understand systems, etc., and the amount of work shown in other sections of the working papers. The structured approach normally interrelates transactions, systems, procedures performed, and assurances achieved in relation to the transaction stream and resulting year-end balances.

What Audit Strategy For Mostly Predictive Aspects of Financial Information?

This area of audit activities relates mostly to subjective and complex decisions made by engagement management in relation to the necessary valuation decisions inherent in generally accepted accounting principles.

Consider this analysis of the different approaches:

- *Unique Approach.* Usually whoever develops the audit approach would make these difficult decisions. Although some generalization is necessary, the audit work should be directly helpful to these significant audit decisions.
- *Structured Approach.* This approach provides an integrated presentation in relation to major transaction streams and assessments of risk, how those risks were dealt with, and the related conclusions (why more work was done and the results of that work). In effect, it is an integrated view segmented by major groups of transactions and balances.
- *Predesigned Approach.* This approach is usually a segmented articulation of work performed, accounts analyzed, and points to be considered. Integration of the audit work requires specific work by the manager or partner at this point to get information from the audit that is necessary to make these difficult and complex decisions.

Overall Assessment—Effect on Audit

While all these different audit strategies can work, their differences should be considered when deciding which one is best or when to use each one.

Unique Approach. This approach places the responsibility for planning the whole audit on management group personnel. If a firm does not have a defined way of performing its audit, then the auditor who will be making the final decision or some other auditor with a very high level of skill and ability would have to plan the audit. The fact that a person at this level needs to be involved in the planning of the part of the audit dealing with mostly predictive information does not justify the need to have to do all the planning. This stipulation seems excessive and inefficient. It should not be necessary for a professional at this level to interrelate all of the detail previously described in the section for mostly factual information. Further, since the mostly factual area addresses a large segment of audit work performed by the audit staff, is it not also incumbent on this planner to do most of the supervision and staff guidance necessary? Few would or could adequately describe in an audit plan all of the matters that they believe the staff should be alert to when performing this work. At the same time, in firms and audits where the partner works closely with one or two audit team members, this could not only be a good approach but more than likely the best approach. Therefore, where there is frequent and direct supervision, review, and guidance of the audit staff, this approach works well. However, it probably would not provide a good base for building audit skills, since most staff members would be reluctant to constantly be asking questions about why such an approach was taken.

Predesigned Approach. In small entities and simpler environments, a predesigned approach can work well because the number of audit options is limited. There may only be two or three different approaches that could be used in a year-end audit of a small entity where control systems are adequate enough to make the entity auditable and to enable the design of substantive tests; however, no reliance could be placed on such controls in performing an audit. Except for these circumstances, the predesigned approach is severely limited in that it can miss actual important risks and allocate excessive work in relation to risk in other areas. It also does not provide a good basis for developing audit skills since staff will normally be presented with an approach thought to be sufficient for the specific audit. It does not provide insight into why it is sufficient for the specific circumstance because it is a general program. Moreover, it invariably states that modification should be made, but without a framework, modifications are difficult to make and not always welcomed. Usually, modifications require reasoning and, with the exception of doing more work because problems were found, reduction of the work without a framework is difficult to justify and can even be dangerous.

Structured Approach. This approach provides a framework of the major transactions or balances and the assessment of the nature of the risk in relation to the possibility that material error or irregularities may exist. This approach is quite different in the way it relates to auditors' planning and performance. It requires that they study the company and *think* through their own plan as to what is necessary. Consequently, the person performing the task is much more aware of why the task is performed and what the results of the work might mean. The structured approach moves the responsibility for actual involvement in audit strategy much closer to those who perform the task than do the other approaches. But it does require a clear understanding and use of the skills and knowledge of the specific individual who will perform the task; it also requires firms using this approach to provide training in audit techniques, theory, and the interrelationships of the audit to the work they will perform. (For example, Touche Ross has a comprehensive curriculum that segments these considerations in relation to the audit task that each staff member is authorized to perform.) This approach also brings the focus of audit strategy much closer to the person who will do the work so as to provide the basis needed to assess the results of the work performed. While this effect is a key as to why it is a good approach, a significant investment in training and on-the-job supervision is required. If the staff is engaged mostly in audit activities or closely related activities, it is cost effective. On the other hand, if audit work is infrequent, it is doubtful if the investment required will be cost effective.

The Effect of Different Audit Approaches on Staff

Auditing is not only a demanding profession, but it is also one where a person never stops learning: for example, understanding many different kinds and sizes of businesses; how management organizes for success; and different control systems and control strategies. Which audit process is used also affects how much the staff learns and determines who should perform what procedures. The predesigned approach obviously provides the least possibility for staff growth in relation to particular auditing procedures. In that it *is* a predesigned approach, those using it are predisposed to accepting the approach and are reluctant to tailor it extensively. Also, they might be discouraged by engagement management from substantially tailoring the predesigned approach because it may require more extensive justification to specify why the predesigned approach was tailored than to execute the predesigned approach.

Similarly, the unique approach designed by an experienced auditor leaves the staff with little ability to tailor because it is prepared by a more experienced person. The staff would be reluctant to use their insights to challenge a more senior person who likely will be reviewing their work and determining what is appropriate in the circumstances.

The structured approach, on the other hand, specifies that interrelationships should exist within a framework of dealing with the risks in an audit and would not only provide a basis to allow earlier involvement in audit planning but would provide more clarity as to the objective of the work performed. As a result, individuals think through their part of the audit with transactions and risk as a guide. They would be more inclined to tailor programs specifically to the risk since there is no general program available dealing with the specific way to plan this part of the audit. Depending upon what plans the firm has for people, the audit approach could be significant. The structured approach requires individuals to think through the process in relation to the specific risk they will be dealing with. Thus, it encourages them to be intensive in their consideration of the risk and specific in relation to how those risks are dealt with. At the same time, it requires that more planning time be given in a specific audit to this process of thinking through the audit objectives and how they can be achieved. Therefore, it requires more time in planning than ordinarily would be the case in the other approaches.

However, if the firm's desire is to build a strong business consultation function with its auditors, then dealing with objectives and how objectives are met in an early part of the career of an individual auditor is a good strategy. On the other hand, if the firm is oriented to delivery of an audit at least cost, then the time spent by people struggling with risks and how risks can be met in specific circumstances may not turn out to be the way to accomplish that objective most effectively. In fact, having a more senior person plan and directly participate in a large part of the audit may actually result in similar objectives being met with less total cost.

Summary

The decision points for the best approach are within the firm and how it actually practices. On balance, the structured approach for firms that have substantial audit work provides a vehicle for staff development and a clearer understanding of the work they are performing. It provides a framework that all levels of staff can understand and use in determining what work needs to be done and interrelating their work to achieve the audit objective. In essence, it provides a vehicle for the staff to understand the audit objectives they are assigned, to design effective approaches, and indeed, even to challenge approaches in a logical and knowledgeable way.