

Chapter 14

Common Audit Deficiencies under the Audit Quality Microscope

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Abstract The quality of an audit becomes visible as the auditor inspects the correspondence level between the established criteria and the presented information by using the International Standards on Auditing (ISA). The way of applying ISAs may differ in variety of situations in accordance with the auditor's professional judgement. In this manner, trying to evaluate the quality of audits and how high quality audits can be achieved needs to be set by several indicators in accordance with International Quality Control Standard 1 (ISQC 1). Audit quality indicators are a combination of qualitative and quantitative measures, there is no single measure of audit quality. The use of Information Technologies (IT) through business methods and internal controls has preferably increased its importance for those same information technologies to be used in auditing and assurance services. New areas of auditing and assurance services have opened up with the digitalization process of the world. There has been argument about whether the IT will replace the accounting profession, whether IT systems will replace auditors. It is indisputable that using IT systems in auditing process increase the quality of the audit without increasing the time spent on the audited data. However, this introduces new technological and business risks that the auditor will need to assess. Accordingly, the expectation from the quality of auditing has increased, but what about the results of the regulatory bodies? Enhanced discussions, in turn, may strengthen audit quality. This chapter explains the key elements that create an environment for audit quality focusing on the audit deficiencies related to the inspection reports from the world's audit regulators. Building/enhancing trust via audit quality cannot be formulized by algorithms or particular standards or obligations. The meaning of evaluation of audit quality depends on the conditions facing the auditor. Measuring professional skepticism, due care or professional judgement are critical factors affecting audit quality. For this reason a comparison is made between Turkish Oversight Authority(KGK) and International Forum of Independent Audit Regulators (IFIAR) inspection reports.

Key Words: Audit deficiency, Audit quality, Auditor ratification, Audit quality indicators, International Forum of Independent Regulators, Auditing and assurance services, International Standards on Auditing

14.1 Introduction

A quality audit will ensure that the financial statements reflect the underlying economic reality of the firm in a transparent way. The quality of an audit consists of six fundamental elements according to the international standards (International Standard on Quality Control-1 / ISQC 1, Quality Control for firms that Perform Audits and Reviews of Financial Statements, and Other

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Assurance and Related Services Engagements) published by the International Auditing and Assurance Standards Board. ISQC 1 or national regulations that are at least demanding, deal with the audit firm responsibilities to establish and maintain a system to provide reasonable assurance.

The firm shall establish and maintain a quality control system which includes policies and procedures that address the following elements: (IAASB, 2018: 47)

1. Leadership responsibilities for quality within the firm
2. Relevant ethical requirements
3. Acceptance and continuance of client relationships and specific engagements
4. Human resources
5. Engagement performance
6. Monitoring

In this chapter we will theoretically study the common audit deficiencies regarding the quality control inspection reports of audit regulators and effects of it on the implementation of high-quality international auditing and assurance standards. The results of the chapter will point out the key points for an engagement quality control inspection.

14.2 Implementation of ISAs

The touchstone of audit is the implementation of ISA's as a matter of professional judgement. In this context considerations specific to smaller firms stand out. In this Regard Small- and Medium- sized Practices (SMPs) advisory group supports IFAC's (International Federation of Accountants) activities contributing the international standard-setting process.

ISQC 1 does not call for compliance with requirements that are irrelevant. Considering Small and Medium Entities (SME) audits assignment of personnel to the engagement team, review responsibilities, and monitoring to engagement partners are not relevant in the absence of personnel. Also documentation and communication of policies and procedures for smaller firms may be less formal and extensive. (IAASB, 2018: 57) As a result, promoting a culture based on quality is the responsibility of the audit engagement partner. In some cases, none of the firm's audit engagements may meet the criteria that would subject them to such a review, for example audit of non-listed companies.

ISQC 1 is applicable to firms of all sizes. For sure, the implementation level of controls will differ depending on the size of a company. Professional standards are principle based and application of relevant audit procedures in accordance with ISA's are related with the professional judgement of the auditor.

In such cases a documented audit approach designed to provide reasonable assurance of the financial statements compliance level with the established criteria will be the main issue for adopting the ISAs. A deficiency in the firm's quality control system does not necessarily indicate that a particular audit engagement was not performed in accordance with international standards and applicable regulations, or that the auditor's opinion was not appropriate. (IAASB, 2018, 150)

But the effectiveness of audit approach/team and the cost of the audit will be affected. It's expected that less effort per engagement team member will result in lower audit quality, which may result in higher audit deficiencies. In this case, the departures from the GAAP^[AB1] in preparing the financials or audit failures need to be expected. In this case it's also a case for the audit client to get much more information about their auditors. Engagement quality control reviewer conducting his/her inspection/monitoring in relation to quality control of compliance with the auditing and quality control standards and firm's quality control policies and procedures becomes important.

14.3 Common Audit Deficiencies

The challenges and deficiencies faced by SMPs implementing the professional standards arise due to their size and limited resources. (Pan & Arnold, 2014) Thus, (Kang, Farag, Robert, & Wyrick, 2014: 731) recent studies show that SMP's not having enough professionals, low human capital leverage and serving too many issuer clients affects audit quality negatively. Auditor reports worldwide have such a high deficiency rate (%33) (IFIAR, 2020), which may have an effect on the audit expectation gap. Another study found that the size of the firm was less important than the number of audits that it performed. (Ashenfarb, 2018)

Table 14.1. Historical Survey Results

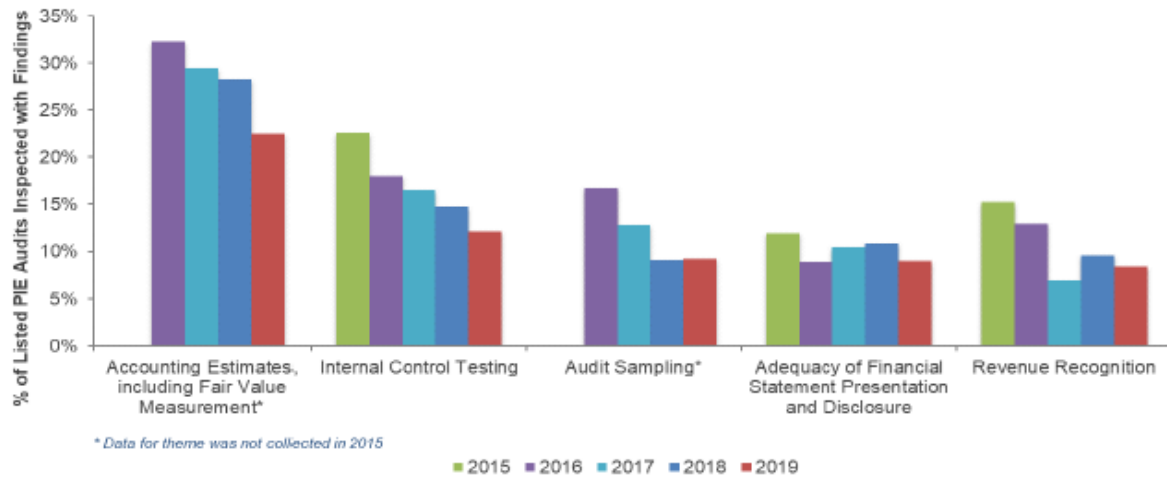
2014	2015	2016	2017	2018	2019
47%	43%	42%	40%	37%	33%

Source: IFIAR, (2020). Survey of Inspection Findings 2019

As seen from the survey results conducted on public interest entities, the general downward trend in the audit deficiency percentage continued from 2014 to 2019. The financial information users may think that the audit quality increases in IFIAR member regulators.

But as mentioned in their survey, it is not designed to – and does not- provide a complete measure of firms' audit quality level. But the identified deficiencies as a result of the inspections should not be the only decision point of the report users. Other quantitative and qualitative indicators should be taken into account to assess the audit quality. (IFIAR, 2020, s. 2) On the contrary the results of a study (Son, Song, & Park, 2017) suggest that shareholders seem not to incorporate inspection reports as a potential proxy for auditor quality in their decisions on auditor ratification.

Graph 14.1. Listed PIE Audits Inspected with Findings^[AB2]



Graph 14.1. Listed PIE Audits Inspected with Findings^[AB3], Source: IFIAR (2020). Survey of Inspection Findings 2019

According to IFIAR’s Global Audit Quality (GAQ) Working Group study results, most faced audit deficiencies are listed in Graph 14.1.

According to the Public Oversight Accounting and Auditing Standards Authority of Turkey 2018 Annual Inspection Report (T.C. Kamu Gözetimi Muhasebe ve Denetim Standartları Kurumu, 2018), most common deficiencies are listed according to frequency of occurrence as given below:

- 1- Findings related to inventories
- 2- Findings related to the auditor’s responsibilities relating to fraud
- 3- Findings related to identifying and assessing the risks of material misstatement through understanding the entity and its environment
- 4- Findings related to revenue recognition
- 5- Findings related to tangible assets
- 6- Findings related to forming an opinion on financial statements
- 7- Findings related to confirmations
- 8- Findings related to the auditor’s responses to assessed risks
- 9- Findings related to going concern
- 10- Findings related to related parties

The deficiencies identified in the file inspections cannot be generalized due to the fact that the file selections to be analyzed are based on risk analysis and the audit firms and independent auditors are obliged to be reviewed within a minimum period of time. When the frequency of the findings in the audit files is analyzed, it can be observed that the frequency of the common deficiencies for each audit file in 2018, compared to 2016 and 2017, decreased. Considering the frequency of the findings in the audit files, the decrease in the findings determined per audit file in 2018 compared to the other two years is remarkable.

Besides, the economic pressures on accounting firms to maximize the leverage of their human resources may result in unrealistic workloads on engagement team, which may affect the audit quality. (Chang, Luo, & Zhou, 2017) Chang et al. posit that it is nearly impossible for a SMP spreading their audit out over many months to arrive at the same overall effort level as a larger audit firm. As a result of their research, firms with audit deficiencies usually have high workloads for their team members.

Another output of a study is in general, it shows that auditors were not responsive to the public oversight boards feedback on their audits and even did not remediate observed deficiencies by their next inspection. (Calderon, Song, & Wang, 2016: 39)^[AB4]

Even though there are studies focusing on large audit firms (Church & Shefchik, 2012), however we take the view that the studies need to focus on emerging markets. As such we have tried to summarize and compare the deficiencies commonly faced in Turkey.

Chart 14.1. Top 5 Common Audit Deficiencies

2016	
KGK	IFIAR
1 Understanding the internal controls	Accounting estimates, including fair value measurement
2 Auditor’s responsibilities relating to fraud	Internal control testing
3 Quality Control System	Audit sampling
4 Auditor’s responses to assessed risks	Revenue recognition
5 Documentation	Substantive analytical procedures
2017	
KGK	IFIAR
1 Auditor’s responsibilities relating to fraud	Accounting estimates, including fair value measurement
2 Identifying and assessing the risks of material misstatement	Internal control testing
3 Auditor’s responses to assessed risks	Audit sampling
4 Related parties	Group audits
5 Going concern	Revenue recognition
2018	
KGK	IFIAR
1 Inventories	Accounting estimates, including fair value measurement
2 Tangible assets	Internal control testing
3 Auditor’s responsibilities relating to fraud	Adequacy of financial statement presentation and disclosure
4 Revenue recognition	Revenue recognition
5 Going concern	Audit sampling

Source: KGK&IFIAR, Survey of Inspection Findings Comparison (Prepared by the authors)

The deficiencies detected by KGK are not similar with the results of IFIAR. The reasons of this could be a subject for another study. There may be an effect of tax and audit awareness, culture, work load, firm size, audit approach, financial information users’ expectation, application of ISAs and more. But in general a comprehensive framework will be a benchmarking opportunity to present the reasons of the differences between these two results. According to Chart 14.1, the inspection findings compared between KGK and IFIAR has engrossing results. Auditing profession is spreading widely in Turkey in accordance with ISAs, that is also a relatively new issue for the KGK which is built in 2011. As seen from Chart 14.1, the common deficiencies reported by IFIAR are nearly the same for the three years period but when the top 5 deficiencies are listed in the case of Turkey, the differences and the variations for the same periods are conspicuous.

If the 3 years period is examined, it can be seen that auditor's responsibilities related to fraud are reported as a deficiency in KGK reports but cannot be seen in the top 5 deficiencies in IFIAR's. Undoubtedly, the primary responsibility for preventing and detecting fraud is on the management. However, the auditor's responsibility is to obtain reasonable assurance that the financial statements as a whole are free from material misstatements. Certainly, applying these principle-based standards in an ongoing tax oriented system may be one of the reasons of changing deficiencies.

14.4 Conclusion

The aim of financial reporting is to provide relevant, timely and reliable financial reports including disclosures that cover the needs of the all related financial information users. Independent audit on the other hand is often required to give users confidence. Understanding the common audit deficiencies may help the related professionals while using the auditor's report for their decision making. Otherwise the implementation of ISA's for today's complex business environment will be much more confusing for the users and may have a negative effect on the audit expectation gap especially SMPs working in emerging markets.

In accordance with the aim of the study, regarding the Survey of Inspection Findings of IFIAR, it is found that measuring the audit quality empirically or statistically is arduous depending on the demographics and cultural differences. The quantitative factors that may affect the audit quality resulting to deficiencies could be summarized as identified areas for further studies discussion. Because it's a complex subject that cannot be analyzed and recognized universally more studies are required in this area. (Sakin, 2019: 25)

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