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b) Kertas kerja Seminar

Zamimi Awang. (1994). *Micro Accounting System for Medical Care Service Programme*, Paper presented at the Malaysian Ministry of Health Micro Accounting System Course (October), Kuala Lumpur, mimeo.

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d) Akta

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ATTESTATION AUDITS REVISITED : HOW ABOUT PERFORMANCE AUDITS FOR PUBLIC COMPANIES?¹³

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ABSTRACT

The primary objective of this paper is to study the possibility of making performance audits mandatory initially at least for all publicly-listed companies. Auditing the performance of management and commenting on how economically, efficiently and effectively they have performed their duties is not a new subject. However, up until now the results of performance audits have usually been kept within the organization concerned ('in-house'). With the growth of perceived dissatisfaction with current auditing practices and the demand for more management accountability due to corporate collapses, this paper considers the possibility of performance audits being made mandatory. Problems to be overcome in establishing a performance audit framework include audit independence, cost/benefit decisions and the establishment of adequate measurement criteria. However, if the demands for performance audits escalate these problems will have to be overcome. Indeed they are not now seen as insurmountable. If the general public and the business community consider that this is the function they want an audit to perform in the future, for all entities both public and private, then performance auditing may acquire just as important a status as currently held by financial statements auditing. Therefore debate over the potential benefits of compulsory performance audits continues to increase.

1.0 INTRODUCTION

External auditing is an important function in the business environment (Watts and Zimmerman, 1983). Legislation exists in most Western countries to ensure that the function is mandatory for public companies (Arpan and Radebaugh, 1985). Even if auditing was not legislated for, Watts and Zimmerman argue that the function of external auditing would continue to exist, as it is an efficient method of reducing overall contract costs for an entity (ibid, p.633). The latter refers to all manner of costs likely to be incurred when transacting business with the particular entity concerned.

External auditing serves many purposes. It can act to monitor the performance of management on behalf of shareholders or as a demonstration by management to existing and potential shareholders of their effort and performance. The former is usually referred to as the 'monitoring role' performed by external auditors while the latter purpose is referred to as the 'signaling role' performed by the independent external auditors.

¹³A version of this paper was presented at the 4th Annual Conference of the Asian Academic Accounting Association (AAAA), held at Seoul National University, Seoul, South Korea on 21st October 2003

Herbert (1979:3) notes how traditionally, the purpose of accounts examination or auditing used to be to detect fraud and certify the accuracy of records, whereas the primary purpose now is to express an opinion on the truth and fairness of presentation of the financial statements. The latter role of auditing, also known as the ‘attest function’ is to simply add credence to the truth and fairness of the financial statements and to confirm that they comply in all material respects with the statutory requirements of any relevant legislation.

2.0 EXTENSIONS TO THE ROLE OF EXTERNAL AUDITING

To ensure that the actual audit performance corresponds more closely to expectations of the different user groups, Gwilliam (1987: 64) notes that the auditors’ attestation role could be extended to include systems and performance auditing (encompassing the ‘audit’ of internal controls).

A potential benefit from extending the scope of the statutory audit beyond the traditional attest function, into areas encompassing performance audits would be their role in narrowing what is commonly referred to in the audit literature as the Audit Expectation Gap (henceforth referred to as the “expectation gap”). The latter exists due to differences between the public’s perceptions of the auditor’s role and responsibilities and what auditors actually do in practice. Blair (1990) describes the expectation gap as the difference between what auditors do and what the users of audit reports think they receive.

3.0 THE CONCEPT OF PERFORMANCE AUDITING

Performance auditing, whereby auditors review and comment on internal controls, has become a topic of concern for auditors as a measure to be used in the pursuit of financial accountability. This type of auditing has come to be viewed by some, usually non-practitioners in the audit area, as a procedure that is complimentary to attest auditing. The realisation of the worth of performance auditing has encouraged both academics and practitioners to address it in a meaningful and concerted manner.¹⁴

This begs the question, what is a performance audit and how does it differ from the conventional ‘attest’ audit? Gill and Cosserat (1996) define a performance audit as one which involves the process of obtaining and evaluating evidence about the economy, efficiency and effectiveness of an entity’s operating activities in relation to specified objectives. This type of audit is also referred to as value-for-money (VFM) auditing, operational auditing, management auditing or efficiency auditing (*ibid.* p.5).

¹⁴See for example Herbert (1979); Brown et al (1982); Parker (1986); Guthrie et al (1990)

In the literature, the above terms are often used interchangeably, to connote the same operation or activity. In fact, according to Parker (1986:11) they are to all intents and purposes identical in the prescription of their constituent elements, with all focusing upon the evaluation of economy, efficiency and effectiveness of resource utilisation, operation procedures and activities, and the pursuit of objectives.

There was a spate of large corporate collapses and corporate scandals in the late 1980s and early 1990s in a number of Western countries. As mentioned by Godsell (1990) the demise of Estate Mortgage, Spedley Group, National Safety Council of Victoria and Tricontinental Corporation in Australia all resulted in legal proceedings against the audit firms involved. This in turn led to an increase in the demand for greater management accountability from some sectors of the business community.

More recently the collapse of Barings Bank PLC in the United Kingdom in 1995 brought into the limelight the question of auditor's responsibility to report publicly on the efficacy of internal controls. Sinha (1995) in his analysis of the Barings PLC collapse attributes it to the almost total failure of internal control mechanisms in place.

In response to similar concerns in the United States, the American Institute of Certified Public Accountants (AICPA) issued a white paper in June 1993 which proposed that the Securities and Exchange Commission (SEC) establish a reporting system requiring public companies to state whether the internal controls over their financial reporting were effective. Independent auditors would then be required to publicly comment on the validity of management's assertions.

The motivation for this paper is derived from the perceived dissatisfaction which exists among some user groups of financial statements with certain aspects of current auditing practices. This dissatisfaction appears to have existed for some time. As far back as 1973, Beck (1973) surveyed two thousand shareholders selected at random from the share registers of two major Australian companies and found that a surprisingly large 81% of the respondents thought an auditor's work assured them, that there was a basis for considering the entity audited to be financially sound. Another study by Steen (1989) in the United Kingdom found that 25% of a subset of participants described as influential believed that auditors guaranteed the financial soundness of the entity being audited.

Based on some of the above findings, it is quite obvious that an audit expectation gap appears to exist. As mentioned above, this is the difference between the role the audit profession perceives auditing plays in the business environment and the general public's perception of what function auditors currently serve. The expectation gap also incorporates the difference between auditor's current functions and functions the general public considers they should be performing. The expectation gap and the increase in litigation involving auditors referred to earlier, would taken together, suggest a level of dissatisfaction with certain aspects of the traditional external audit function.

In light of this perceived dissatisfaction and the demand for more management accountability due to widespread corporate failures some of which were mentioned earlier, this paper looks at the possibility of extending the role of auditors beyond their traditional attest and statutory compliance functions to incorporate inter alia reporting on internal controls. In other words, this paper tries to explore the possibility of making performance audits mandatory, initially at least for publicly listed companies.

O'Leary (1996) comments on how performance audits have traditionally been conducted by the internal audit departments of the entities under audit. The results of these audits have usually been kept very much "in-house". Internal auditors have been requested to review an area and report back to management on how economically, efficiently or effectively that area has been managed during the period under review.

As the findings may not always be complimentary to management they have been reluctant to disclose them to the members of the entity or to the general public.

Therefore, the important issues to be posed are:

- (i) Whether the users of the financial statements of the entity concerned would like to have this information, and
- (ii) Whether the members of the entity concerned are reasonably entitled to have access to information of this nature relating to the efficient and effective performance of the present management team.

There are many potential problematic areas that will have to be tackled and overcome before a mandatory performance audit framework can be established. If however, the pressure for performance audits escalates, then ways will have to be found to overcome some of these potential problem areas. According to some writers like O'Leary (1996), these are not in fact insurmountable problems.

This in turn leads to questions about the purpose of the audit function and further, about what is in store in the future. A review of the origins and history of auditing, as it is traditionally understood is therefore pertinent.

4.0 THE ORIGINS OF AUDITING

Brown (1962) comments on how auditing can be traced back to the days of the Roman Empire. Similarly, Gill and Cosserat (1996) note that in ancient Egypt authorities provided for independent checks on the recording of tax receipts. In early Greece, inspections were made of the accounts of public officials, and the Romans compared disbursements with payment authorisations.

Further, Gill and Cosserat (1996) note how the early records of auditing were primarily confined to public accounts, with those handling public monies required to attend before a responsible official known as the auditor who heard their accounting for such funds. The latter was similar to the approach taken by a judge hearing the evidence of witnesses at a trial. The word 'auditor' is derived from the Latin *audire* – 'to hear'.

The authors also describe the practice of the government in medieval England of sending auditors on circuit to manors and estates to hear an accounting for disbursement and revenues. This practice contributed to the stable financial condition of the English Crown.

Traditionally auditing only performed a stewardship function. It informed the members of an entity whether management of that entity, to whom they had entrusted their capital, had invested it as planned and could account for its current whereabouts.

It is interesting to note that a statement of audit objectives published in a practice manual by Dicksee (1892) stated the object of an audit to be threefold:

- (i) the detection of fraud;
- (ii) the detection of technical errors; and
- (iii) the detection of errors of principle.

Auditing practice evolved over time. In the early part of the twentieth century it was recognised that some reliance on internal control was possible. It now appears as if the practice of auditing has turned a complete cycle from its early beginnings. In what might be referred to as the formative days of auditing, it was popularly held that the chief objects of an audit were the detection and prevention of both fraud and errors, to the latter day view that the auditor was merely expressing an opinion and not certifying or guaranteeing the accuracy of the records (the latter is also known as the 'attest' role).

Today it appears that there is a move by some sectors for an extension to the traditional attest role to incorporate amongst other things, a performance audit with an auditor being required to express a public opinion on the efficacy or otherwise of a company's system of internal controls.

As we are in the new millennium, the recipients of financial statements have become a far more sophisticated and informed group. They demand more from an audit function than a mere attestation that their investments can still be accounted for. Accounting standards have necessitated the issuance of a lot more than bare profit and loss and balance sheet figures. Significantly more additional data has to be given these days. Consider for instance, the voluminous notes, which, nowadays, accompany published financial statements. Items such as segment information, related party transactions and lease commitments to name but a few, are now part and parcel of the Annual Report of most entities. Auditors now have to comment on these data as well as the basic accounts. Hence auditing has expanded from its traditional stewardship role to one of a more informative nature as well.

The brief history of auditing outlined earlier demonstrates an interesting point. Auditing is a profession and just like any other profession it is dynamic and not static. It will grow and adapt as the demands of the users of that profession change over time. According to O'Leary (1996) currently a level of dissatisfaction can be perceived worldwide, with what an audit function is seen to provide, and Malaysia is not immune to this global trend. This is due partly to the audit expectation gap referred to earlier.

As reported in Gwilliam (1987) the American Institute of Certified Public Accountants (AICPA) established the Cohen Commission in 1974 inter alia to consider whether a gap may exist between what the public expects or needs and what auditors can and should reasonably expect to accomplish. Gwilliam (1987) notes how in respect of its primary brief, the Commission came to the conclusion that such a gap does exist.

However, the Commission noted that principal responsibility does not appear to lie with the users of financial statements. The Commission considered that the main reason for this "expectations gap" was the failure of the public accounting profession (or auditors) to react and evolve rapidly enough to keep pace with the speed of change in the business environment.

Blair (1990) further expands on the functions which an audit does not perform. He notes that an audit is not an assurance of the future viability of an entity. It is not an opinion on the economy, efficiency or effectiveness with which management has conducted its affairs, nor is it an assurance that there has been no fraud or other irregularity. His comment on management performance is interesting. Like many others, these comments appear to mirror some members of the public's expectations as to what an audit service should offer.

Some users of accounts obviously feel that auditors should comment on management's performance for the period under review, as well as reporting on the accuracy of the financial statements of that entity.

The audit expectation gap is, unfortunately, a current fact of life and while it exists, it will continue to cause criticism of and litigation against auditors, and to undermine confidence in their work. According to Porter (1991), if irreparable damage to the profession's reputation is to be prevented, the auditing profession must take urgent and effective action to narrow the gap.

Porter (1991) notes how in recent years, the profession, particularly in Britain and the United States, has taken some positive steps to narrow the gap, but that these efforts have generally been fire-fighting in nature, targeted to quell the most vociferous and scathing criticism of auditors, or else they have been enforced by legislation and designed to serve specific objectives.

5.0 LIMITATIONS AND PROBLEMS WITH IMPLEMENTING PERFORMANCE AUDITS

From a review of the literature, it appears that there is a lack of support for recommendations that the auditors' traditional attestation role be extended to incorporate performance audits amongst other functions. Boys (1985), Santocki (1976), Edmonds (1983), Smith & Lanier (1970), and Smith et al (1972) discovered amongst other things that auditors were unwilling to perform such audits due to the wider responsibilities being undertaken. Gwilliam (1987) also attributed the reluctance to take on these additional tasks to the threat of greater legal exposure.

There are many limitations and potential problematic areas that will have to be tackled and overcome before a mandatory performance audit framework can be established. O'Leary (1996) foresees three major problems which can arise as a result of attempting to implement performance audits on a mandatory basis.

Briefly, some of the pitfalls include:

- (i) Loss of audit independence
- (ii) Cost/benefit considerations and
- (iii) The establishment of adequate measurement criteria.

5.1 Auditor independence

As mentioned earlier, most large organizations currently conduct some form of performance auditing via their internal audit departments. Given their in-depth knowledge of the entity which employs them, internal auditors are in the ideal position to comment on management's efficiency and effectiveness or otherwise. However, by definition, they cannot be expected to conduct the performance audit function with complete objectivity. Even if they could, the perception of independence would be extremely clouded.

The ideal alternative is of course to utilize an entity's external auditors to conduct a performance audit, as well as the mandatory financial statements audit. Their knowledge of the client's operations will be reasonable but certainly not as thorough as that of the internal auditors. Hence if the external auditors perform the function, this raises the second problem, cost.

5.2 Cost/Benefit

Information always comes at a price. Whereas the shareholders of a company (or the members of any audited entity) and the general public would almost certainly welcome comments as to how economically, efficiently and effectively management of an entity has performed its functions, they will probably only welcome such additional information if it is obtainable at a reasonable price. Significant time, effort and resources would have to be employed in conducting any worthwhile performance audit. It would be expected that management would wish to recoup these costs from shareholders, be it by way of additional contribution or reduced returns (dividend payments, etc). This would appear reasonable as shareholders would be the major beneficiaries of the additional review function, i.e. the performance audit.

As mentioned in Gwilliam (1987), a general problem which arises when considering the possibility of such extensions to the traditional audit role, lies in the lack of evidence as to the potential costs and benefits. The fact that there is generally no prohibition upon many of these services being offered and purchased at present seems to suggest a priori that in the majority of instances, the costs currently exceed the benefits.

5.3 Establishing measurement criteria

One of the major difficulties with performance audits is how to establish measurement criteria. Commenting on what is economic, efficient and effective is obviously not as clear-cut as commenting on dollar and cent valuations and results. Performance evaluations may be highly subjective unless adequate guidelines are set against which performances can be gauged. It is critical therefore in a performance audit that the audit objective be properly defined so that the results of the investigation can be assessed correctly. However, setting the objective for a performance audit as opposed to a financial statements audit will not usually be as straightforward. This is due to the lack of a succinct meaning for the terms *economic*, *efficient* and *effective*.

6.0 COMMENTS

The above three difficulties may partly explain why the concept of issuing the results of performance audits to outside parties has not yet been embraced readily by some elements of the financial community. However, these problems are not insurmountable. The difficulty of a lack of independence can easily be overcome by having the performance audits conducted by external audit firms, and this may not necessarily result in exorbitant costs which have to be passed on to the members of the entity. The external auditors must already possess a sound knowledge of their clients' operations.

The work carried out by Boys (1985) in the United Kingdom found that there was already a very considerable overlap between performance auditing and the work of the management consultancy divisions of professional accounting firms. Hence the finding that accounting firms were much more prepared to countenance the auditor in this additional role, since the extra costs if any, were likely to be marginal. When carrying out the audit of financial statements, the external auditors usually review several aspects of management performance. For instance the auditor should obtain an understanding of the internal control structure in order to plan the audit and develop an effective audit approach. This means that the auditors are bound to review and assess the effect of the internal controls on the entity. The by-product of this function is often seen in the letter of recommendation. Arens et al (1990) comments that a secondary purpose of many financial statement audits is to also make operational recommendations to management.

Costs can further be reduced by the external auditors assessing the workings of the audit entity's own internal audit department. If they are satisfied that this department is competent and acts independently of management pressure, they are entitled to rely on their work to a large extent.

If this is allowable for a financial statement audit, why not for a performance audit as well? Relying on the performance audit work of the internal audit department would greatly reduce the cost to the external auditors of performing an independent review. Hence, it may be quite feasible to have external auditors conduct performance audits without the costs becoming too prohibitive.

This then leaves us with just the problem of establishing adequate measurement criteria. Here again, however, significant progress has already been achieved. In the United States, Charnes and Cooper (1980) attempted to develop a method of evaluating management efficiency which did not necessitate the use of imputed market prices. Their new method uses complex linear programming techniques.

Sherman (1984) then compared the performance of these techniques, which he termed ‘data envelopment analysis’ (DEA), with the techniques of financial ratio analysis and analytical review which are traditionally employed by auditors as part of their performance audits. He found DEA better able to capture efficiency dimensions not covered by the more traditional methods of evaluation. Sherman suggests two valid reasons for the use of DEA techniques.

Firstly DEA can provide technical measures of efficiency, thereby abstracting from all the problems associated with internal cost allocations (this also includes those situations where market imperfections allow for high profitability in spite of operating inefficiencies) and secondly, it is better able to account for expenditures such as training, research and development, etc which contribute to future output but are not taken into account in arriving at more current measures of profitability.

Therefore the gist of the arguments against mandatory performance audits as well as their proposed remedies can be summarized briefly in the table below as follows:

**Figure 1 : Implementation of mandatory performance audit
(problems / solutions)**

	Problems	Proposed Solutions
1	Loss of audit independence	<ul style="list-style-type: none"> • Require external auditors to carry out performance audits
2	Cost/Benefit	<ul style="list-style-type: none"> • Reduce costs by accessing the resources of the in-house Internal Audit Department
3	Establishing adequate measurement criteria	<ul style="list-style-type: none"> • Using linear programming techniques termed data envelopment analysis (DEA) • Redefinition of the measurement criteria

In some countries like Australia the fact that the audit practice statement AUP 33 (and the subsequent AUS 806) has already been in issue since 1992 indicates that a fairly high degree of agreement already exists as to what the measurement criteria entail. The three critical words in performance auditing, economy, efficiency and effectiveness are well defined therein. While they are still prone to a certain degree of subjectivity in their implementation, they are certainly not as nebulous as some commentators would have us believe. With time the measurement criteria can be refined and re-defined if necessary.

Hence the problems associated with performance auditing should not be considered insurmountable. With careful planning, monitoring and implementation, they can be overcome.

7.0 CONCLUSION

The issue of the audit practice statement AUP 33 in 1992 heralded the official recognition of performance auditing by the auditing profession in Australia. Certain members of the business community and some academics believe it to be the future of auditing worldwide. Rather than just the traditional financial statement audit, in years to come audit firms may have to comment on management performance as well as the accounts under review, in conducting their periodic reviews of audit entities.

Questionnaire studies and other evidence suggest that user groups see the auditor as performing a wider function than that encompassed by the presently limited scope of the financial audit. A number of possible changes in, and extensions to, the audit function have been suggested so as to ensure that the actual audit performance corresponds more closely to the expectations of various user groups. Research work relating to this problem of the audit expectation gap and some suggested solutions has been reviewed earlier.

Smith et al (1972) who undertook a survey into the need for and scope of the audit of management's performance, concluded from their study that because of management's relationship to the rest of society, the question of need is academic, maintaining that there is a very clear need and that the remaining important issues only revolve around the questions of scope and appropriate professional standards.

It must be borne in mind in relation to the latter, that their comments were made almost a quarter of a century ago. The latter would no longer appear to be an important issue since professional standards covering the area of performance auditing have already been in issue in Australia since 1992 and it is only a matter of time before other countries in the region follow suit.

Similarly, Beck (1973) performed an empirical appraisal looking at the role of the auditor in modern society and made the following observations:

If the ascribed role is not fully performed there arises the possibility that social action will be taken to enforce conformity (perhaps by new legislation or to downgrade the status and thus shrink the role. As a role develops only out of social wants, it is axiomatic that the void created by a reduced role will, in due course, be filled by other social functionaries prepared to satisfy those social wants. (p.118)

He then goes further, noting that:

It may be doubtful whether any other credible source can provide information of this kind: but auditors certainly should be aware that it is wanted and that a significant proportion of shareholders expect auditors to supply it (p.121).

Porter (1991) concludes from her research investigating the structure and composition of the audit expectation gap that auditors are failing to meet society's expectations in relation to their corporate watchdog function. The auditing profession has usually downplayed the latter role, yet survey results consistently demonstrate that auditors' stakeholders expect auditors to perform these additional duties.

These concerns of both Beck and Porter amongst others have been borne out in recent years by the additional responsibilities imposed on auditors in many parts of the English-speaking world through legislation.

Much of the information presented in corporate annual reports which is generally not covered by the external auditor's opinion is important for making sound investment decisions. The purpose of this paper therefore, has been to consider whether the external auditor's attest function should be extended by mandate to incorporate performance auditing. Probably the only significant barriers at the present time to extending the attest function to include information outside the financial statements are the economic and legal implications of any such proposed extension.

Perhaps recent developments, such as the clarification of legal responsibilities and the development of accounting standards and procedures which lessen time and cost limitations, will lessen the effect of these obstacles.

External auditors should seize this opportunity to extend their services to society wherever desirable and feasible. Failure to do so promptly may well have the undesirable consequence of weakening their claims to being the principal attester in our contemporary society.

Mautz and Sharaf (1961) presented the challenge confronting the profession very clearly, noting as follows :

As the public requires more and more verified information, much of it well beyond that currently found in financial statements, will auditing see and seize the opportunity to extend its range of service? If it does, there are literally no bounds to its future. If on the other hand, it either deliberately or unconsciously limits itself to but a small fraction of the total of verifiable information, its position of eminence may be lost to those who do seize the larger opportunity. (p.200)

Although these observations were made more than forty years ago, there seems to be a ringing truth to their predictions in light of the current controversies surrounding the suggestions made about the extension of the auditor's role to incorporate mandatory performance auditing.

If the general public and the business community consider that this is the function they want an audit to perform in the future, for all entities both public and private, then performance auditing may acquire just as important a status as financial statement auditing currently holds. Therefore debate over the potential benefits of compulsory performance audits continues to increase both in Malaysia and overseas.

In conclusion, irrespective of whatever role the audit profession wishes to ascribe to auditors, in the long run the public will shall be expected to prevail. The profession of auditors must be seen to possess considerable economic power, albeit indirectly, for in the absence of a functioning auditing profession the economic structure in most English-speaking countries will be different and corporate organisations as we understand it will disappear. The following comments attributed to Berle (1960) apply no less to auditors: 'we have considered public consensus, if not as originator, certainly as final arbiter of legitimacy' (p.111).

It seems reasonable to view the public consensus concerning the role of auditor as in a state of continuous change or development, but generally speaking, there is a small likelihood of sudden or dramatic change in this consensus. Although these last comments were made as the result of a study undertaken by Beck in Australia almost three decades ago, it is suggested here that they are still valid and can be taken as reflecting the extant role of the auditor.

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