

## RETROSPECTIVE OF POSITION AND SOLUTION OF THE AUDIT QUALITY PROBLEM: FROM THE PROFESSION TO THE INSTITUTE OF AUDIT

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### Abstract

The content of this article is focused on examining the historical retrospective of the positions of posing and solving the audit quality problem that has been formed throughout the establishment of the audit institute under the existing conflict of public hopes entrusted to the audit and the quality of its conduct. The object of research is the institution of audit.

The purpose of the research was to identify the features and patterns of development of the audit institution in Russia and abroad.

**Keywords:** audit, audit activity, audit quality

## 1 INTRODUCTION

### Before The Professional Audit Period:

Audit, as a kind of professional activity, in its historical development is a reflection of socio-economic relations, and the institutional and cultural conditions in which it exists. From the point of view of the consideration of the institutional environment in which the profession, specializing in checking accounting practices and reporting on business operations, controllers, originated and received initial registration, it should be noted that this process was conducted in all states according to informal rules based on customs and traditions of these countries and peoples. Professor Malkova T.N. gives numerous examples of confirmation of credibility of accounting information by third-party inspectors in the practice of lending in Mesopotamia [22, p.91-112], as well as evidence in court proceedings, determination of taxes, spending of the state treasury in Ancient Greece and Rome. [22, p.138-148; p.154-157; from p. 203-208; from p. 214-230]

The main practices that entered the future profession were checking the availability of property (inventory) and recalculation.

The public-legal orientation of the "conclusions" about the inspections conducted by the controller-inspectors, which were essentially the forerunners of future professional auditors, lasted in the traditions of many states

up to the industrial revolution of the 18th century. According to Professor V. Pankov before, in the home of the audit, in England, there were two forms of audit: public - with hearing of the auditor's oral report; and an audit to verify the accuracy of accounts - with the issuance of an "audit declaration" [26, p. 139].

Other authors [24, Chapter 1] insist that these forms from the point of view development of audit have a more concrete meaning in the sense that in the public form, the auditor's report was read out because of the overwhelming illiteracy of the population, in the squares as heralds, and from the 16th century ended with the list of "undersigned auditors".

Referring to the opinion of Robert Montgomery (1872-1953) and his book "Audit: Theory and Practice" (1912), which in subsequent editions was called "Montgomery Audit" [34], show that a detailed audit of income and expense accounts of finance managers of large farms, ended with an oral report of the auditor to the owner. It is important that according to the conclusions of the authors this audit is the precursor of modern internal audit [18].

From the point of view of our consideration, both positions testify to the development of audit in the framework of informal rules of the institutional environment and were part of the traditions of business life aimed at ensuring accountability of officials.

With the writing of the treatise of Luca Pacioli (1494), the discovery of America (1496) and the associated emergence and rapid development of bourgeois economic relations, it was necessary to understand the importance of internal control as a single standard accounting system that guarantees the safety of capital and the receipt of dividends by shareholders. In the audit, there were techniques for detailed analysis of documentation and studies of supporting evidence of the correctness and objectivity of audited financial statements, as well as the likelihood of continuing activities of enterprises and companies.

The final registration as a kind of professional activity is audited in 1854 year, with the establishment of the Edinburgh Society of Accountants, and in 1880 year the Institute of Chartered Accountants in England and Wales, which emerged from the merger of five professional auditing public organizations. The Institute still exists, and in its 100th anniversary, 76 thousand professional auditors united around the world [3, p.13].

#### Period Of Legal Recognition of Audit -1862-1904 Years:

Stage 1862 – 1914 year [3, p.13-14] institutional development of audit - the period of legal recognition of the need for auditing in the economic life of countries (See Table 1).

**Table 1. The chronology of the introduction of formal rules in the institutional environment of the audit (1862-1914 years)**

Date /Year	Country	The name of normative act
1862	United Kingdom	The British Companies Act
1867	France	Law on Joint-Stock Companies
1870	Germany	Law on Joint-Stock Companies (supplement)
1871	Germany	Court of Auditors of the German Empire
1886	USA	Law on Chartered Accountants

Source: compiled by the authors based on [3, c.13-14], [9], [17], [34]

The British Companies Act of 1862 year and the Joint Stock Companies Act, enacted in France in 1867 year, introduced an annual compulsory verification of accounts. In addition to the main part of the Law on Joint Stock Companies of the German Empire, it was mandatory to inform shareholders about the results of an audit of the balance sheet and its applications. The reason for this was the so-called. "Grunder's fever" (1850-1873 years) -economic recovery, which led to the rapid creation and the same rapid destruction of many joint-stock companies, prompting legislators to provide for compulsory audit.

The Law on Chartered Accountants, which was called "The Accounting Act" (1896) [9, p. 14], passed in the state of New York, consolidated the legal recognition of the audit of both professional and entrepreneurial activities. Within five years, similar laws were passed in 25 states. It is important that the release of this legislative act marked the appearance in the audit community of the second world audit center - the United States.

Legal recognition of the need for audit has determined a number of fundamental requirements for auditor activity and the auditor's personality - honesty, conscientiousness, professionalism, independence and understanding auditing professions (knowledge of psychology) [3, p.13]).

Created by this time rather numerous national public organizations of auditors, introduced strict requirements

to professional competencies and ethical standards of sworn accountants. Since that time, the qualification of accountants-auditors is confirmed by passing the special exam.

The authors come to the conclusion that the formalization of the rules for the implementation of the professional functions of auditors has caused the emergence of traditions that formed the basis for educational and practical requirements for the applicant for the profession. In different interpretations they are present now in all national associations of auditors. It should be noted that at the end of the 19th century, higher education institutions were not taught accounting, so English jurors accounted for such functions by determining the set and scope of knowledge, which included studying except for accounting, the development of economic and legal disciplines that ensure quality work performed by their members. So, the educational plane was laid in the formation of the institute of audit [27].

According to Professor Baranov P.P. at the same time there have been trends in the creation of a theoretical basis for auditing [5, p.14]. The starting point for this judgment is the approach to determining the essence of the audit itself and its goals in the writings of L. Dixie (1892) and A. Watson (1889) [32]. Quoting the authors [5, p.107], L. Dixie "defined the audit as a work connected with the confirmation of the correctness and objectivity of the balance (1892), which can be performed by checking documents and inventorying values.

Professor Pankov V.V. [31, pp. 158-159] emphasizes the importance for the audit institution of determining the initial need, due to the presence of complex, and sometimes diametrically opposed interests of the interested parties in the audit activity.

Professor Sotnikova L.V. [32, p.29] considering the measures proposed by L.R. Dixie to prevent falsification of reporting, provides a list of 5 points with a range of proposals from the frequency of checks, the recommendation of simultaneous inventorying in all places of storage of material assets, before sending requests to counterparties when checking receivables and payables.

In the same direction worked A.T. Watson, whose merit consists in determining the three directions of falsification of reporting - the asset is shown more than in reality, the amount of capital is overstated or understated [31, p.108]. Derrick Matthews [23] reviews the terms of contracting "agreements" to conduct audits of 22 British companies, including the seaports of England, international telegraph and transport companies, banks and large hotels in London, which testifies to rational behavior audit firms in the market subsystem, as well as the formation of one of the most enduring routines - the formation of prices for audit services from the value of the "balance currency" of the client. "Completion of the semantic binding" of the audit practice with the function of financial control at the state level, for example, expressed in the transformation of the Chief Accounts Chamber of Prussia (1714) into the Court of Auditors of the German Empire (1871).

#### **Awareness of the Audit Mission (1905-2000 Years):**

The chronological frames of this period differ from those adopted in our science earlier [5, p.15-16], which is determined by the adopted direction of consideration of the influence of the institutional environment on the formation of requirements for the quality of audit and audit activities. Therefore, the spectrum of research in this chapter is broader than that of our predecessors [19], [21].

According to Stephen A. Zeff [35, p.190], the basis for the process of forming a new world audit center in the United States was the emigration (1900-1914 years) of a large number of accountants from Scotland and England, who opened their own firm on rendering of accounting and auditing services. Rapidly developing capitalism in the United States has become a fertile ground for projecting the rules of business audit practice in Europe. The result can be considered the fact that by the beginning of the XX century the largest and most influential audit firms. This firm were founded by Arthur Young, George May, Alvin C. Ernst, Robert Montgomery, Arthur E. Andersen. All these names are included in the history of world audit and in our time.

A special place among them is occupied by R. Montgomery (1872-1953 years), whose name is associated with the beginning of the formation of an audit as a science [7, p.7]. Nuri H. and Lambardi D. [25] cite facts that indicate the continuity of R. Montgomery's first scientific propositions from the works of L. Dixie.

Professor Bulyga R.P. [8, p.10] emphasizes the importance of indirect influence on the development of the audit of the global economic crisis of 1929-1933 years, when the numerous bankruptcies of joint-stock companies that followed resulted in the introduction of a number of preventive measures by the US government to ensure the reliability of audits.

The authors acknowledge the importance of the period 1905-1929 years providing basic changes in informal audit rules relating to ethical requirements for the profession, the formation of principles of independence, confidentiality, the design of the algorithm of audit procedures.

In 1930 year, almost immediately after the collapse of the stock market in 1929 year, the New York Stock Exchange asked the American Institute of Certified Public Accountants (further – AICPA) to develop policy principles that should be adopted regarding the financial reporting of corporations placing their securities on it. After three years of extensive discussion, AICPA proposed five reporting indicators mandatory for companies, and in 1934 year approved the standard form of the auditor's report. The committee responsible for the preparation of these documents was headed by George O. May, a senior partner of PriceWaterhouse & Co, an American branch of a well-known network company, which in 1998 year, after the merger with Coopers & Lybrand, is known as PricewaterhouseCoopers (PwC) [30].

To the "victories" of American auditors is the fact that the Senate Committee on Banking and Currency Control recognized the right to verify the accounts of public companies, which was later consolidated in the adoption of the Securities Act (1933 year), although the draft planned to imply this duty to government agencies [35].

In the period 1926 - 1933 years the Dutch scientist Theodor Limperg presented the theory of inspired trust (Theory of Constructed Confidence) [6], formed in the series of articles of the Amsterdam professional journal "Accounting and Business Monthly" [6]. At the same time, the first scandals related to the quality of the audit are included. The most notorious of them was the scandal of 1939 year, related to the company McKesson & Robbins, which was audited by the auditors of Price, Waterhouse & Co. [35]. The audited company overstated the accounts receivable and the value of inventories in the accounts, and the auditors did not bother to verify the reliability of this [35, p.192]. Prior to that, testing of current assets was carried out only at the discretion of the auditors, after this incident AICPA issued a special bulletin on which this procedure became mandatory.

John L. Carey, executive director of AICPA, in his work on the history of the AICPA from 1896 year to 1969 year, defined the boundary of 1936-1937 years as the moment of overcoming the "Rubicon" - the transition of an audit from a technical specialty to a profession [35, p.192].

Registration of basic methods of verification, determination of audit axioms, development of standardized rules of accounting and audit are events that will characterize the triumph of the profession in the time frame of 1940-2000 year.

According to numerous authoritative opinions [1], the introduction of audit methods for risk identification ended the formation of "third generation audit". The idea to consider the progressive development of audit control practices in "generations" belongs to R. Davis (Davis, R.), who in the article "Serving the public interest", published in 1996 year, identified 5 milestones - "generations" of audit in the twentieth century [1].

The end of the 90s year of the last century for the audit was marked by the complete completion of the institutional formation and awareness of its mission in the Society.

The historico-positive method of analyzing the development of the institutionality of the audit, according to the positions of Gutzait E.M. [16, p.32] with a pronounced industry specificity combines two-sided study - the real reality and normative approach, it means formal requirements that must influence this reality. Referring to M. Friedman [16, p.32], Gutzait E.M. expresses the idea that audit, as one of the economic sciences, in its development studies objective reality, abstracting from normative judgments. From which it is logical to draw a conclusion about the primary importance of the scientific reflection of reality and the secondary nature of the regulatory component that influences the "formation of this reality" [16, p.32].

### **Russian Audit:**

Audit in Russia appeared more than 80 years late in comparison with the USA and in 150 years in comparison with the European continent.

According to testimonies [4, p. 12], [8, p. 16] in the middle of the 17th century there already existed an Order of Counting Affairs, which monitored the expenses of the tsarist treasury, already the first mention of financial control in Russia has a close link to the state functions.

At the end of the same 17th century, Peter the 1st created the Middle Chancellery, where the "audit" was first mentioned, but it exists in the goal-setting of control over the expenditure of funds in the army. Only Catherine II establishes the Auditing Office and the General Auditors, who were engaged in audits within the treasury and which existed for 70 years. From 1867 year to 1987 year the word "auditor" disappears from civil use [4, p. 13] and appears only with the release of the Resolution of the Council of Ministers of the USSR of 08.09.1987 "On the establishment of a Soviet audit organization", JSC "Inaudit" [8, p.17] on the provision of audit and consulting services.

The regulation of audit activity in the Russian Federation originates from the Presidential Decree No. 2263 of

the 22 of December, 1993, which approved the "Provisional Rules for Auditing" as an indispensable measure "for the prompt establishment of the legal framework for auditing activity as an independent non-departmental financial control" [29]. "Provisional rules" were in force until the adoption of the first Law "On Auditing" (further- 119- FL) [14]. The formation of the market of audit services began in 1994 year with the issuance of a government decree on compulsory audit [10], regulations for certification of auditors and issuance of licenses for auditing [11].

Undoubtedly the catalyst in the formation of audit in Russia was the beginning in 1996 year of the development of audit standards by the Commission under the President of Russia. The licensing procedure was amended in 1999 year [12] and was canceled from 01.01.2010 year by the release of the Federal Law "On Audit Activities" in 2008 year (further- 307-FL) (15, art. 23, item 2).

Professor Bulyga R.P. emphasizes that at this time for the practice of Russian audit is characteristic of the anticipation of the existing regulatory framework [8, p.20], which was expressed in the provision of a wide range of services, often with low quality.

119-FL legally enshrined mandatory quality assurance audit firms (Article 14, paragraph 1), assigning the Ministry of Finance the functions of external control, while ensuring the use of the forces of accredited professional associations. Researchers [2], [13], [28], on the whole, agree that the 2001 year Audit Law was of a conceptual nature, as evidenced by the fundamental approaches placed in it that determine the functioning of the audit activity in Russia (See Fig. 1).

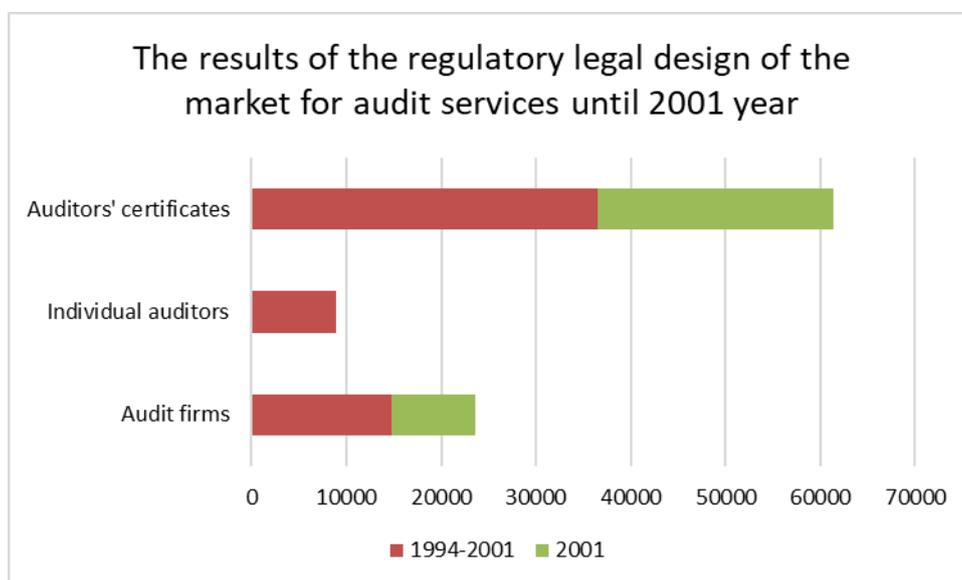


Fig.1. the results of the regulatory legal design of the market for audit services until 2001 year

Source: compiled by the authors based on [13]

The concept of a self-regulating model in its functional development, according to Professor Bulyga R.P. fully corresponded to the American way of development of the audit until 2002 year. The reservation "until 2002" is connected, according to the professor, with changes within the business community after a well-known scandal with a positive conclusion issued by the falsified reporting of the company "Enron" by Arthur-Andersen ".

The mixed model is justified by the Russian model of audit after the adoption of the Law "On Auditing" in 2008 year (307 - FL). This fateful event was preceded by painstaking work of the authorized federal body, the Central Attestation and Licensing Audit Commission (further - CALAC), the Audit Council (further - AC) and professional self-regulating organizations of auditors (further - SROA).

For the modern stage of the evolution of the institution of audit is characterized by the introduction and mandatory use from 01.01.2018 year. International Standards on Auditing (hereinafter - ISA). The authors do not share the categorical opinions of the negative attitude towards the ISA, because see in their practical purpose not only a unified complex that provides mutual guarantees of institutional relationships, but requirements on the basis of which the audit institution can be subjected to assessments of the professional quality of work both within its egregor and on the part of the interested community. Another characteristic element of the management reform of the domestic audit is the revision of the global audit law (307-FL) which, since autumn 2017, is in the development and approval of the State Duma of the Russian Federation,

as well as the prospects for a global reform of the audit market from late 2018 year to 2021 year and the next. The platform for reforming the audit activity, the development of the digital economy [33], and the approaches [20] that provides economic security countries.

## **2 SOURCES AND METHODS**

**The methodology** used consists of a set of procedural methods that, with their systematic use, have allowed them to focus on observing the positions of setting and solving the audit quality problem in Russia and abroad in historical, institutional, comparative, monographic and analytical approaches to research.

The informational array of the study was the data placed in free access: information from the Ministry of Finance of Russia; reports of self-regulatory organizations of auditors (hereinafter - SROA), publications of domestic and foreign authors.

## **3 RESULTS**

The authors analyzed and systematized the historical set of approaches for determining the success of the audit institute, both in Russia and abroad.

## **4 CONCLUSIONS**

The Institute of Russian Audit, organically fitting into modern society, is slowly evolving in its development, directing its professional activities to support and fulfil state tasks, sensitively reacting to changes in international requirements and foreign approaches to quality. Successfully continues to improve national audit standards, expressed in the creation of their new version – International accounting standards (IAS), which consolidates ties with international experience in providing audit services.

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