

Module: Auditing

Session 10: AUDIT FAILURES

Introduction

- In modern societies, external auditing is promoted as a technology that enables the stakeholders to manage, control and prevent risks. However, a steady stream of audit failures shows that it is also a technology that harms people. Audit failures are routinely implicated with loss deposits, loss of employments and loss of livelihoods of individuals.

Example of audit failures and its effects to individuals:

- The damage done to people's lives by audit failures is well documented. Audit failures played a part in a crisis for 30,000 Maxwell pensioners (House of Commons Social Security Committee, 1992). Audit failures played a part in the closure of Polly Peck and the loss of 17,227 jobs (Mitchell et al, 1991) and losses to 11,000 shareholders of Sound Diffusion Plc (Department of Trade and Industry, 1991a).
- Auditors failed to note that frauds that led to the conviction of five officials of the Baptist Foundation of Arizona on 32 counts of fraud, racketeering and theft. 11,000 investors lost £400 million (Daily Mail, 2 April 2002).
- The US Senate's report on the closure of the Bank of Credit and Commerce International (BCCI) concluded, "There can be no question that the auditing process failed to work" (US Senate, 1992, p 253). The audit failures were associated with the loss of 14,000 jobs and losses to some one million bank depositors with deposits of US\$ 1.85 billion (US Senate, 1992, p 75).
- The Senate Report accused auditors of being a party to a "cover up" (US Senate, 1992b, p 276) and causing "substantial injury to innocent depositors and customers of BCCI" (US Senate, 1992, p 5). In the aftermath of the 1970s audit failures at secondary banks, property and insurance companies, the UK taxpayer had to spend £3,000 million to bail out the sectors (Reid, 1982).
- The frauds and audit failures at Barlow Clowes required the British taxpayer to spend £153 million in compensation to investors (Department of Trade and Industry, 1995; Parliamentary Commissioner for Administration, 1989). The real/alleged audit failures in the US Saving and Loans industry may have cost the taxpayers between \$400-\$500 billion in bailouts (Pizzo et al, 1990).
- The collapse of Enron, the world's largest bankruptcy, is associated with audit failures in which the audit firm devised corporate structures, created numerous subsidiaries (including 900 offshore) and financial transactions. Enron auditors, Arthur Andersen, performed consultancy services, including internal audit and just as the regulators were poised

to examine the failures, the firm allegedly shredded a number of relevant electronic and paper documents(Financial Times, 11 March)

The cause of audit failure:

- The scenario has become all too common in corporate world. A large publically quoted companies receives an unqualified audit report and shortly thereafter collapse with the news that the financial statements are grossly misstated.
- Audit failures occurs when there is a serious distortion of the financial that not reflected in the audit reports and auditors has made a serious errors in the conduct of the audit.
- The nature of this auditors errors has only four systematic causes:
 1. The auditors can blunder by misapplying or interpreting GAAP or GAAS; such blunders are unintentional and could be caused by human errors and fatigue.
 2. The auditors commit fraud knowingly issue more favourable audit report than is warranted. This may occur when the auditors accept bribe or bows to client pressure or threats from the audit client.
 3. The auditor can be unduly influenced by having direct or indirect financial interest in the audit client. For example audit practice provide significant amount of non audit services to audit client and will be reluctant to questioned the audit client fearing losing the client.
 4. The auditors can be unduly influenced because of having some personal relationship with the client beyond what is expected in a normal audit between independent parties. For example it is common for audit staff members of audit firm to leave their employment and join the former audit client in senior capacity.
- Audit failures can be avoided if the auditor has followed the GAAP and GAAS, regardless of the fairness and accuracy of the financial statements.
- The public perception is that the auditors secondary duties is to is detected any possible fraud and report to those in charge of governance of the company.
- Misconceptions about the auditors' responsibilities for going concern and fraud are a major component of the 'expectation gap' which exists between what users of financial statements expect (often unreasonably) and what auditors can reasonably be expected to deliver.

- There will be an audit failure when an auditor does not adhere to a basic principle or carry out an essential procedure in accordance with International Standards on Auditing (ISAs). For example, if an auditor issues an unmodified opinion knowing that it is inappropriate, that is negligent.
- Auditor failure can also arise through incompetence. For example, where the auditor does not have sufficient understanding of the risks involved in the reporting of earnings or measuring fair values.

Issues raised by the regulator aftermath of Audit Failures:

Significant concerns have been raised about many issues including:

- Responsibilities for the detection of fraud.
- The rigor of financial reporting and auditing standards.
- Auditor independence.
- Monitoring, enforcement and regulatory mechanisms in the profession.
- The quality of corporate governance.
- The capital market and its regulators have become more sceptical about the value of the auditor's role and the credibility of the financial statements in the wake of 'scandals' which reveal too 'cosy' relationships between companies and their auditors. In particular:
 1. the provision of other non-audit services for fees which far outweigh audit fees; and
 2. Senior finance executives being former auditors.
- Frameworks of principles (e.g. IFAC's 'Professional Code of Ethics') are just theory to many who now call for an end to self-regulation of the profession and demand much stricter legal regimes of monitoring and enforcement (however unworkable).
- Auditors are likely to be perceived to be at fault when legalistic, rules-based standards facilitate creative accounting practices which devalue and even undermine their judgement.
- However, 'real' earnings are clearly inflated to a normal person. Although stock exchange listing provisions may require a minimum number of independent directors to sit on audit committees (e.g. in the US, UK, Netherlands, etc) this does not mean that they will have sufficient expertise to be effective in providing corporate governance.

Possible response by Audit profession

- There is already wide support for the application of International Accounting Standards in financial reporting. By embracing one set of such principles-based standards on a global basis, the auditing profession can dismiss the rules-based approaches which can currently undermine an auditor's judgement. ACCA, for example, supports a 'think global: act local' view.
- The profession should undertake a review of the regimes for monitoring compliance with professional guidance (e.g. the Joint Monitoring Unit for UK statutory work and mandatory peer reviews in the US) and the enforcement mechanisms which support them.

On the issue of auditor independence it has been suggested that:

- a limit could be placed on the time which auditors may hold appointments; and
- Auditors are prohibited from undertaking consulting work. Although these measures have been debated for many years and already operate at a national level in some countries, they have been discounted as a global solution. An alternative approach is to make relationships between reporting entities and their auditors more transparent. For example, by:
 1. Making audit appointments less dependent on executive directors through the greater involvement of non-executive directors, the audit committee and institutional shareholders.
 2. Limiting the nature and extent of 'other services' which can be offered to listed and other public interest clients.
 3. Requiring fuller disclosure of audit fees, including expenses, and other fees in the financial statements.
 4. A mandatory review by audit committees of the independence of the external auditors and the publication of a statement that they are satisfied with their findings.
- It has also been suggested that audit firms should be prohibited from providing audit services to clients where senior audit staff have left the audit firm to take up executive positions within the client company. This might be implemented by prohibiting staff from leaving to join client companies within a minimum specified period from having been personally involved with the audit.
- However, this may not be practicable as employment contracts which prevent auditors from leaving their firms for 18 months (say) may not be enforceable.

- It is often argued that one way in which the profession could respond to issues which contribute to the 'expectation gap' is to educate users to overcome misconceptions about the audit process. So for example, the standard wording of auditors' reports has been revised to refer to the applicable financial reporting framework. However, although the auditors' report tells the user what an audit is – it does not explain what it is not. Perhaps it is time for the auditors' report:
 1. To state, explicitly, that it does not guarantee going concern; and to include a disclaimer of responsibility for the detection of fraud.
- Perhaps one of the reasons for 'genuine' audit failure (e.g. where the auditor lacks competence) is because too much is expected from the average auditor in terms of knowledge and experience of business risks, IT, systems, etc.
- The syllabus of professional qualifications is periodically revised, to be made more relevant, and qualifications can be made harder, the competence of those who are already qualified must also be assured (e.g. through compulsory continuing professional development and statutory licence renewal procedures).

Conclusion

- Audit failure is perceived to be linked, directly or indirectly, with corporate failures. So, if company failures are unavoidable, 'audit failures' will happen – however effective the auditing profession's response.