Challenges Before Auditing Profession

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The audit profession is facing its toughest challenges ever. A couple of years ago none could have imagined the demise of Andersen. Failure on the part of auditors to detect the financial shenanigans has drawn criticism from various quarters. The response of regulators and the proposed reforms in the form of Sarbanes-Oxley Act indicates the emerging challenges to the profession.

The users who are not familiar with the internal accounting process of the company depend upon expert opinion for taking decisions. Auditing is a systematic independent examination of accounting systems, accounting records and financial statements of a business or a company with an objective to inform the users, particularly the shareholders, who mandate the auditors to this job for a fee, as to whether the report provide a true and fair view of the business's activities. The large-scale accounting frauds or misrepresentation of the reports has resulted in increased scrutinization of the role of auditors. Beasley et. al. undertook a study on the companies that filed accounting reports with Securities Exchange Commission (SEC) of the US and were allegedly involved in accounting frauds and fraudulent financial reporting during 1999. They found that external auditors were named in about 29% of the cases either for being involved in the fraud or for negligent auditing. And surprisingly, in 25% of the cases, companies have changed auditors prior to the fraudulent financial reporting period. Malpractice suits have become increasingly common in the US in recent years as a result of complaints that auditors protected their clients at the expense of investors. There are cases in which auditors claim that they have also been duped along with the investors. This paper examines how the role of auditors can be strengthened to serve the purpose for which their service is used.

Management, Auditors and Shareholders

The role of auditors can be best understood by looking into the kind of corporate structure the modern companies adopt. Large companies today are owned by several millions of small and big shareholders. The management of such companies' vests with the Board of Directors, who in turn delegate, the responsibility to several managers. Financial statements prepared by the managers and approved by the Board are expected to reflect the performance of the company and in turn performance of the management. The conflict of interest between the management and shareholders under normal circumstances is reflected in such financial statements and this gives incentive for the management to suppress the true and fair view of the performance. There are several ways in which management may distort the accounting numbers. Levitt in his speech on September 28, 1998 discussed five key illusions poisoning the financial reporting process. They are big-bath

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charges, creative acquisition accounting, miscellaneous cookie-jar reserves, materiality and revenue recognition. The survey on accounting fraud, which was quoted earlier, listed improper revenue recognition and overstatement of assets to be the two prominent financial frauds. A further analysis shows that some of the common revenue fraud techniques include sham sales, premature recognition of sales before the completion of all terms of sales, recognizing revenues of subsequent period, unauthorized shipments and consignment sales. Inventory and accounts receivables are two items which are often misstated. The shareholders believe that auditors, who are trained to examine the accounting records can easily identify such frauds and force the management to revise the accounting statements before they are reported to the shareholders. It may not be possible for auditors to prevent all frauds that are happening within the company, but the presence of an auditor itself is expected to reduce the frauds. They are expected to be like the police whose presence, sometime help to prevent crimes. The basic issue is, why is this not happening? Despite taking huge audit fees, why accounting frauds are on the increasing trend? There could be two possible reasons. One, the auditors may lack adequate knowledge or professionalism to detect the accounting frauds. Here, managers are smarter than the auditors are and thereby the auditors also get duped along with others. Two, auditors may not be independent and collude with the management.

Lack of Fraud-detection Knowledge

The businesses are so complex and highly diversified, often the investors get lost in the umpteen issues on the company in the press that he loses his sight on the performance of the company. Corporate sector today has become highly diversified in terms of product lines, services and also in terms of geographical location. There is also considerable complexity in the way in which business transactions are performed. Often, such complex business practices are to exploit certain tax laws to save money for the organization. The ultimate result is that the auditor's job is highly challenging and may not be able to comprehend the kind of frauds that the management has created. It is also quite possible that auditors perform the job mechanically without looking into many details beyond the correctness of the transactions. For instance, SunBeam Corporation had to restate its earnings because of improper accounting procedures. The auditor could have easily set right the accounting fault, if someone in the audit team had questioned the surging sales of heating blankets in the summer or barbecue grills in late fall. SunBeam later acknowledged it was booking sales before the goods were actually delivered to stores. How to improve the auditing standard or practices is one of the key issues being debated among the auditing professional bodies all over the world.

The AICPA Auditing Standards Board (ASB) took a major step towards in addressing this problem by issuing an Exposure Draft (ED) of a proposed Statement on Auditing Standards, Consideration of Fraud in a Financial Statement Audit, which would supersede SAS No.82. The ED does not change any of the auditor's current responsibilities for fraud in a Financial Statement Audit. However, it introduces new concepts, requirements and guidelines to assist auditors in meeting those responsibilities. In applying the proposed guidance, auditors would plan and perform every audit with a skeptical mind, recognizing the possibility that a material misstatement due to fraud could be present, regardless of past experience with the entity or prior beliefs about the management's honesty and integrity. An extract of the few tips stated under the ED[1] is given below:

- To increase awareness and sensitivity to fraud, and to enhance the fraud-risk assessment process, the audit team members discuss during the planning stage the

[1] Montgomery D D, Beasley M S, Menelaides S L, Zoe-Vonna Palmrose, Auditors' new procedures for detecting fraud *Journal of Accountancy*; New York; May 2002, Pp. 63-66

potential for material misstatements due to fraud. The more experienced team members should share their insights, and all the members should exchange ideas about how and where the entity's financial statements might be susceptible to material misstatements due to fraud.

- Auditors to query management on its views of the risks of fraud in the entity and knowledge of any known or suspected fraud. It also says auditors should query others—for example, individuals outside the entity's accounting or financial reporting areas or employees with varying levels of authority.
- Revenue recognition issues have been at the center of numerous instances of fraudulent financial reporting and continue to be the number-one reason for restating financial statements. Auditors ordinarily will identify a risk of material misstatement due to fraud relating to revenue recognition. In addition, analytical procedures would be required during planning to help identify unusual or unexpected relationships involving revenue or related accounts.
- Several instances of fraudulent financial reporting involved the manipulation of the financial statements through unauthorized journal entries or other so-called top-side adjustments. Many auditors already may review unusual or "non-standard" journal entries. However, the auditor's understanding of the entity's financial reporting process, including automated and manual procedures used to prepare financial statements and related disclosures, and how misstatements may occur, is critical.
- Fraudulent financial reporting often is accomplished through intentional misstatement of accounting estimates. Existing auditing standards already require the auditor to consider the potential for management bias when reviewing significant estimates. In addition, auditor needs to perform a retrospective review of significant prior-year estimates for any potential bias that might signal inappropriate earnings management (for example, recorded estimates clustered at one end of an acceptable range in the prior year and at the other end of an acceptable range in the current year).
- Evaluating the business rationale for significant unusual transactions. The use of complex business structures and sophisticated transactions, especially transactions involving special purpose entities or related parties, has been making headlines recently. Although the auditor typically gains an understanding of significant transactions, greater focus on understanding the underlying business rationale for significant unusual transactions is required.

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Auditors' Collusion with the Management

Although the auditors are independent, the users should be aware of the fact that the auditor is hired by the firm whose financial statements are under review. The auditors are actually recommended by the directors for appointment. Though technically shareholders appoint the auditors at the company's annual general meeting. In addition to getting considerable amount of money from consulting assignments auditors are paid huge auditing fees by the company.

The auditors do not wish to upset the directors and forego such remunerative audit and consulting fees. In the case of Enron, Andersen earned more from the consultancy rather than from auditing their books.

Some estimates suggest that Big Five audit firms receive more than 50% of their income from non-auditing services. This dual role of auditing firms cast doubt on the independence of auditing, and hence the Sarbane's Oxley Act 2002 was passed. To improve the quality of auditing, the Act listed out some requirements, like:

- All audit and non-audit services (with some exceptions) must be pre-approved by the audit committee of the company, and such approval must be disclosed to investors.
- Audit partners must be rotated every five fiscal years.
- Auditing firms must report to audit committees, the recommended alternative accounting treatments that have been discussed with management.
- Auditing firms cannot provide audit services to a

company if a former employee of the auditing firm who participated in an audit of the company within the past year now serves as CEO or CFO for the company or holds a similar position".

The SEC is now demanding that it should be given the right "to specify non-audit services that deem to compromise the independence and objectivity of external audit."[2] This is to ensure that external auditors will not be influenced by non-audit services that it may be doing for the firms whose financial statements they are auditing.

Given the kind of flexibility in accounting policies, it is possible for some auditors to accommodate the wishes of the management in choosing a particular accounting policy, though it may not be appropriate. In many cases, the absence of accounting policies also helps the auditors to give "true and fair view" opinion. Today, several malpractice suits increasingly complain that auditors protected the clients at the expense of investors. How does the collusion of interest take place between the management and auditors? Executives' face missed earnings expectations or a tight bank-lending covenant, and their bonuses hang in the balance. They need to do something to protect their company from getting into financial trouble while ensuring incentives for them. Some of the usual accounting frauds come handy.

If the company's competitors pursue similar practices, executives are motivated to ask auditors to accept the standard set by the leaders. This race will actually pull down the whole industry standard. Another concern for regulators is the coziness that can develop between auditors and their clients[3]. For reasons of career diversification and pay, many auditors switch over to the corporate finance staffs of their old clients. Corporate books end up being audited by the executives' former partners. Robert S Miller, who was brought in to clean up a mess at Waste Management Inc., believes that may have been one factor behind the alleged accounting irregularities that led the company to restate six years of earnings downward by $1.75 bn. Many finance executives had come from Andersen, he says, creating "too much of a close relationship between senior auditors and senior managers."

There is some evidence to show the collusion between the auditors and management in accounting frauds. Between the years 1990 and 1999 about 47 companies in the USA restated their financial statements with significant accounting adjustments. In 2000 there were over 150. The numbers, still higher for 2001 and 2002. Several of these restatements, particularly the most recent ones, have arisen when there has been a change of auditors. This is clear evidence of a 'cosiness' that existed between management and the former auditors and there have been instances where companies have collapsed due to auditors rotation for every two years (Manuel Trenor, 2002).

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Improving Quality of Auditing

It is difficult to state whether the lack of knowledge arising out of increased complexity of business transaction or auditors' collusion with management is a real reason for accounting frauds. Accounting bodies all over the world are trying to improve quality of audit by bringing out several new audit practices. Recently a few more suggestions were floating around as a way to improve quality of auditing. They are discussed below:

Audit rotation: Rotation of audit has been one of the agendas recently in many countries to bring more transparency in the way the auditors could be made more responsible. This is not a new concept that any country is facing for the first time. Italy has been following the concept of audit rotation on mandatory basis for over 30 years and has not found the concept to be working successfully. Singapore and Brazil too have made the audit rotation mandatory. Would the audit rotation minimize the accounting scams? In a survey conducted by the *Financial Director* (2002) in the US revealed that 57% of the respondents desired for audit rotation, though only a third feel it should be made mandatory.

The suggestion of audit rotation arose mainly because the long-term relationship of the audit firms with the companies they are auditing make them produce biased reports. Thus,

[2] "SEC wants more teeth v. erring accountants", *Businessworld* (Manila) January 14, 2003

[3] Melcher, Richard Where Are the Accountants? *BusinessWeek*; New York; October 5, 1998, p. 144

the basic issue is why auditors align their interest with the management instead of shareholders? Management influences the selection of auditor and fixing their fees. Often audit firms receive substantial additional revenues from the company for providing other services. Thus, as a class the audit firms have every incentive to align their interest with the management. When the management lies, the auditors may also lie because of the long-term good relationship. If we think that the rotation is going to break the long-term relationship and hence bring improvement in audit quality, it is difficult to agree with this argument. Mandatory rotation of audit firms alone may not improve the quality of the audit. A few audit firms may form a small cartel and move between the companies in the name of rotation.

Further, this rotation may not affect the management rewarding for other consulting services to the previous friendly auditors, but in turn may signal the present auditor the need to be friendly with the management. There may not be much incentive to perform well if the tenure of each auditor is very short. Thus its impact depends on how frequently the audit firms are going to be rotated and how long each audit firms will serve the company before facing the rotation wheel exit. Another issue is how long the minimum gap should be for the present auditor to qualify for re-appointment.

Similarly, the cost involved in frequently rotating the auditors need not increase efficiency of the audit. The time required to complete the audit may increase since the new auditor may need more time to understand the internal control systems, procedures and accounting system, but it may not affect the efficiency. One or two years could be too short a tenure as every new audit firm will take lot of their time in the review process of the company which in turn affects the efficiency of the audit. In the case of Italy where audit rotation is mandatory, the rotation is done for every nine years. This could be considered too long a period, hence the Sarbane Oxley Act have settled for a period of five years for the audit rotation.

The staff members of audit firms should be instructed to maintain distance with the employees of the company. It is better to involve multiple teams and that too by rotation in auditing various components. Rotation is more relevant at the audit team level and the shareholders/audit committee of the Board may need to discuss this issue with the audit firm and ensure that there is less scope for the staff members of audit firm to get closer to the management team.

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Peer review: The Institute of Chartered Accountants of India (ICAI), by the powers vested by Section 15 of the Chartered Accounts Act, 1949, issued a Statement on Peer Review in April 2002 that effectively serves as a wake-up call to the profession. Professional firms will be subjected to Peer Review (PR) and those which meet the prescribed criteria will be issued a PR certificate. PR is basically a review by one's equals and is part of self-regulation procedures for ensuring quality in audit. In addition to peer review, the accounts are audited alternatively once in three years, by an additional audit firm selected by minority shareholders or institutional shareholders. Though it adds to the cost of auditing, it is still worth to spend once in three years.

Expanding audit report to include auditor analytical commentary: In its report on 'Improving Business Reporting—A Customer Focus'[4], the AICPA surveyed whether audit reports should be restricted to highly standardized reports or would users benefit from reports that include comments tailored to the specific company and circumstances. A majority of users support expanding auditor reporting to include some form of analytical commentary. Discussion group participants noted that auditors know more about a company than what they communicate in their reports on the company's accounting principles in relation to alternative principles used by other companies in the same industry, reasonableness of significant assumptions and estimates used by the management in preparation of financial statements and risk related to realizing recorded assets. In view of lot of concerns on legal liability, such commentary can be made non-

[4] Improving Business Reporting— A Customer Focus: Meeting the Information Needs of Investors and Creditors, American Institute of Certified Public Accountants, 1994.

binding and submitted to the Audit Committee.

Strong action against auditing firms for professional misconduct: Professional bodies need to improve the ethical standards of the members and also send the right signal to improve their professional skills to provide better service to their clients. Shareholders, who hire auditors, expect certain output from those hired. The law restricts the number of members who could be hired for the service. Hence, it is necessary for the professional bodies to enforce higher disciplinary action against the erring members to help their clients and also create adequate confidence among the other professional members. It is also worthwhile to publish the names of the partners of the accounting firm, which indulge in accounting frauds.

A visit to AICPA website shows the kind of disciplinary action initiated against the members with their names[5]. There is no such publicly available information in the ICAI website though ICAI publishes and sells the disciplinary cases.

Summary and Conclusion

The profession of audit has been in news for all wrong reasons for the last few years. Though the problem that the auditing profession facing is not new, the depth of the problem has been felt so deeply now since the awakening of the naïve investors. The paper had tried to figure out the many reasons for the discrepancies in providing quality audit. When much of the efforts to maintain audit independence to serve the shareholders has been futile, it may be a good idea to take away the voting rights on the appointment of auditors from the promoters, and other manager-shareholders. Further, financial institutions or mutual funds who are dominant shareholders may be authorized to recommend the names. Similarly, the frequency of reporting can be increased. More so, the scope of the audit certification is now very narrow as it was then framed when the business was less complex and management were more ethical and this can be expanded to a large extent to cover more comments from the auditor. This could be made possible when the audit committee of the company encourage the auditor to come out with some of the best practices in treatment of accounting transactions that are applicable to the company. Attention towards implementing these issues could bring a drastic change in the service of auditing profession.■

Though the problem that the auditing profession facing is not new, the depth of the problem has been felt so deeply now since the awakening of the naïve investors

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4. KPMG website (www.kpmg.co.uk).
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Reference # 09-03-02-10

[5] Here is an example of disciplinary action taken by the AICPA against a member.
"In consideration of the ECA foregoing further proceeding in this matter, Carlyle agrees as follows:

- To waive his right to a hearing under AICPA Bylaw Section 7.4 and Missouri Society of CPAs Bylaw Article X, Section 2b.;
- To neither admit nor deny the above-specified charges;
- To be expelled from both the American Institute of CPAs and the Missouri Society of CPAs effective October 24, 2002;
- That the ECA shall publish his name, the charges and the terms of this settlement agreement in an abbreviated format in the printed version of a membership periodical of the AICPA with a more detailed version description of the disciplinary action in the online version of this periodical on the AICPA's website. Also this information will appear in a periodical of the Missouri Society of CPAs."

Source: http://www.aicpa.org/pubs/cpaltr/disciplinary_actions/disc2003.htm#january