HOW CAN WE FIX THE PROBLEMS OF AUDITING?

The Joshua Institute

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Background

The Joshua Institute is an informal, independent think-tank.

In 1998, a project was started to consider the problems facing our society in Australia with the ultimate aim of developing appropriate policies to address these issues. It was motivated by a belief that significant problems exist which are not being adequately addressed and are, in fact, getting worse. In particular, it was felt that the current processes of government are not working as effectively as they should.

The main problems noted were:

1. Growing numbers of people are marginalised within our society and are not sharing fully in its benefits, including:

   - Those who do not have their basic needs adequately met, such as indigenous people in remote communities and the homeless.
   - People without work, both those receiving government benefits and the hidden unemployed who want to work but do not qualify for unemployment benefits.
   - Others reliant on government support.

2. There is a growing gulf between those in government and those being governed, with increasing disaffection with, and even distrust of, politicians reflected in the support for One Nation and independents at all levels of government. This has coincided with the increased demand for government support noted above.

3. Public dissatisfaction with corporate attitudes and behaviour is growing as companies focus more on profit maximisation, increasingly at the expense of employees, customers and communities.

In 2000, the Joshua Institute was created to promote discussion about these problems and possible solutions. This paper is a contribution to this process.

Comments or feedback would be welcomed. The email address for The Joshua Institute is

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Overview

Of late, it seems as though as each week passes, more instances are revealed of past earnings distortions for large companies, including Enron, Worldcom and Xerox. The common themes seem to be the questionable presentation of financial statements by senior management, with or without the knowledge of the Board of Directors, and the failure of external auditors to identify or report these issues. In Australia, the inquiry into the collapse of HIH has indicated similar concerns.

The main results to date of these failings have been:

- considerable losses to shareholders of the companies concerned;

- the loss of confidence across a range of stock markets as investors question the reliability of financial statements in general;

- losses to shareholders in unrelated companies as a result of broad stock market declines;

- loss of confidence in stock market regulators;

- in one notable case, the disintegration of a major global audit partnership.

Overall, the key questions raised have been:

- How can senior management have had so much freedom to produce such misleading earnings results?

- Why were external auditors not aware of items so material that they significantly distorted the earnings results? If they were aware of these matters, how were they allowed to proceed without correction?

Considerable attention is now being given to: the subject of corporate governance, particularly to the oversight of senior management by audit committees and external regulators; to the adequacy and appropriateness of accounting standards; and to perceived deficiencies in the performance of external auditors.

This paper focuses on the issues specifically relating to the role of external auditors and puts forward some potential solutions for discussion.

Specific auditing issues to be addressed

The first issue that has to be addressed is the role of external auditors. From the point of view of shareholders and others, the main reason for having statutory audits is to establish independent certification of a company's financial statements. Do the financial statements accurately and completely portray the financial position of the company?

Regulators are also interested in the independent verification of financial information but their main concern is the audit assessment of the adequacy and effectiveness of the company's system of internal controls.

Most recent attention on audit performance has focused on perceived shortcomings in auditor independence. However, whilst this may have been a significant contributing factor in some cases, there is no reason to suspect that this was the only or main factor behind audit deficiencies. It is also necessary to consider whether the audits have been as thorough or as competently performed as they should have been.

Independence from senior management

Independence is a significant issue and should be clearly demonstrated so that there are no perceptions of bias or partiality. The major problems in this area have already been widely canvassed and discussed.

The main threats to auditor independence are perceived to be:

- The pursuit of consultancy and other additional work. There exists the risk that audit firms will not confront clients with audit issues if this means jeopardising lucrative consultancy opportunities.

- Too close a relationship between client and auditors encouraged by the hiring of former auditor partners and senior managers to client management positions. This can exacerbate real or imagined perceptions of conflicts of interest common to all "revolving-door" situations.

Adequacy and competence of audit performance

Audit fees quoted are often set at unrealistically low levels. This is done to win an audit in the midst of intense competition and to secure an opening for more profitable consulting work. In such cases, they do not reflect a fair value to perform a thorough audit. The expectation is that there will be additional, more rewarding work to compensate.

As a result, the budgeted allocation of resources for the audit once won is usually very tight. Indeed, the audit environment within a professional firm is usually characterised by the tensions between the audit partner and the audit manager, and between the audit manager and junior audit staff, regarding the enforcement of the audit budget and the control of cost over-runs.

These budget constraints are reflected in the allocation of resources peculiar to professional audit firms. The vast majority of audit staff are young, mostly fresh from university, and with very limited experience of the corporate world. For the most part, these staff are used for the mundane testing of controls and processes. Their ability to assess or analyse complex aspects of a company's operations is limited.

Experienced staff are used in audit supervisory and management positions. However, for the most part, these staff will usually be under the age of 35. Their experience may also be limited or confined to narrow areas of expertise. These staff work under the greatest budget constraints, particularly as much of their time will be spent in supervising junior staff.

The most experienced audit staff are the audit partners. The partners are best placed through experience and seniority to discuss and challenge complex issues with senior client management yet the role of the audit partner is also often tightly constrained by the budget. In many cases, the partner or partners involved will have little involvement during the conduct of the audit. Their involvement will often start in earnest once the audit fieldwork has been completed and close to when the audits are due for finalisation.

This structure does not lead to an audit of sufficient thoroughness, certainly to the extent that shareholders would require. There is a clear need for the adequate allocation of resources, particularly of sufficiently experienced auditors.

Possible solutions in respect of audit performance

The level of potential risk relating to the inadequate performance of audits is enormous, as demonstrated by the level of past legal settlements for audits in Australia and overseas. Accordingly, actions to correct audit deficiencies need to be of appropriate strength and scale.

Independence

Real and perceived conflicts of interest need to be transparently resolved:

- Consultancy work should not be performed by audit firms. This prohibition should be extended to those grey areas where accounting advice overlaps with audit work. This will result in increased audit fees for clients and reduced audit efficiency but this is a necessary change to ensure improved audit effectiveness.

- Senior audit staff, particularly managers and partners, should not be hired by the client for a period of, say, five years, from the time of their audit involvement with the client.

Audit firms **must be,** and **must be seen to be**, independent in all circumstances.

Audit performance

Audits need to be more thorough. Audit fees need to reflect the realistic allocation of resources to perform the audit. By separating audit and consultancy activities, there will be no reason to under-quote for audit work. However, the pressures of competition and profit-maximisation may continue to undermine the adequate performance of audits.

A radical alternative would be to remove these twin pressures. This could be achieved by taking the audit function into the public sector. The audit of all listed companies, public trusts and superannuation funds by public sector audit resources would enable more thorough audits to be performed in the absence of profit motives and competition.

The obvious benefits of public sector control would be:

- Greater allocation of experienced resources.
- Clear independence from consulting resources.
- No restriction on audit resources arising from competitive pressures.
- Greater sharing of knowledge and experience, subject to client confidentiality requirements.

The disadvantages would be:

- Lower incomes for those at partner level although this would be offset to some extent by the elimination of the hefty insurance premiums currently faced.
- Potentially higher audit fees for clients, although costs would not reflect the same profit margins or inclusions to cover premiums.

In addition, the quality control and efficiency of audits could be more appropriately and thoroughly checked by an independent body such as the Auditor-General rather than the current internal or peer reviews, which are less likely to act as an effective and impartial control.

Above all, it is important to recognise that external audits and their findings contribute significantly to the function of regulatory oversight by validating key financial information and assessing the effectiveness of key management controls. By taking these audits into the public sector, the risk of delegating such a key responsibility to private sector, profit-driven organisations would be eliminated.

Management responsibility and accountability

Finally, it is inappropriate to consider audit shortcomings without emphasising the ultimate responsibility of client management for the accuracy and completeness of the financial statements. In the face of determined and consistent attempts by client management to mislead auditors, it is almost impossible for auditors to perform their functions properly. Final responsibility and accountability must always rest with company's management and its directors.

The recent spate of corporate earnings restatements demonstrates that, regardless of any changes in audit structure or functions, only concerted action to police management activities will address these problems. After all, if management had done nothing wrong and had not concealed their deeds, there would have been no failures with or without an adequate audit.

To this end, the implementation of an idea recently raised in the US would seem to establish and reinforce the desired level of responsibility and accountability. Executive management, at least including the Managing Director (CEO) and the Chief Financial Officer, should provide the Board of Directors and/or the external auditors with a statement of management representation which states, amongst other things, that the financial statements do present a complete and accurate picture of the company's financial position as far as they are reasonably aware. If their statements were later found to be false, then the penalty applicable would be a prison sentence. Such an approach would certainly sharpen management's focus and act as a serious deterrent to inappropriate behaviour!

Conclusion

The main responsibility for the recent spate of corporate problems rests with management not auditors. However, in some of these cases, the performance of the audits has undoubtedly fallen short of the levels expected by shareholders and the public at large. Auditors must recognise that one of the main functions demanded by shareholders is the independent certification of financial statements. In view of the recent huge losses in shareholder value from mis-stated earnings, if current audit structures cannot meet these demands, then new approaches must be implemented. If auditors are unable to certify that financial statements are accurate and complete, shareholders are clearly entitled to question whether some other approach would better suit their needs.

A new or revised audit framework is called for that ensures:

- the real and perceived independence of auditors; and,
- the allocation of adequate and appropriate audit resources.

It must be emphasised that it is not sufficient to focus solely on the issue of auditor independence to remedy current shortcomings. Audit performance must also be improved.

The “nationalisation” of audits suggested above may appear an extreme proposal but the extraordinary size of recent losses, which must be attributed in part to the role and performance of external auditors, may merit such an approach.

Author’s Note

It should be noted that the author of this paper was formerly a qualified chartered accountant who spent five years as an external auditor in the United Kingdom, three years as a senior external audit manager in Australia and five years as a senior internal audit manager in two large companies. In the course of this experience, the author had extensive exposure to the audit performance of most of the large audit firms, both from a professional auditing perspective and from a client perspective.