Audit: Watchdog or Bloodhound?

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The credibility of the audit profession is under scrutiny after the recent spate of corporate scandals. Being stuck between the role of a bloodhound and that of a watchdog, there is an imminent need for the audit profession to rediscover its ethics and reinvent itself.

An economist, a human resources professional and an accountant met once. For want of anything common, they started discussing what "2 + 2" is equal to.

Economist: Other things being unchanged, 2 + 2 = 4.

HR Person: When two people work with two other people, their synergy would ensure that they do the work of five people.

Accountant: 2 + 2 is equal to whatever number you would like me to make it.

The current problems of accountants and auditors are precisely on account of this professional reality.

- **Accounting is not an exact science.** Unfortunately, the accountants' reputation for reconciliation and tallying balance sheets gives their work an aura of exactness which is misplaced. Shockingly, many accountants are unable to differentiate between this aura and the reality.
- **Accounting is dependent on inputs from others.** Should these inputs be accepted blindly? Or should an attempt be made to understand these inputs? If these inputs are to be "understood" then accountants need to get out of their cosy chairs and go to the shop floor and the market. An accountant whose antennae do not go up when the consumption of tyres in a motor cycle plant is not equal to the number of motor cycles multiplied by 2, needs to find an alternative vocation.

Not since 1494, when a Venetian Monk called Luca Paciolo invented 'Double entry bookkeeping' have so many people wondered if accountancy is some sort of witchcraft, cauldrons, bubbles *et al.*[1] When the accounting process is subjective, it is important for the accountant to be objective and independent. The onus of independence is even more on the auditor, who is expected to validate the work of the accountant. The auditor has to be like "Caeser's wife". Unfortunately, auditors themselves came under a cloud, and the profession finds itself holding the baby created by widespread myopic opportunism.

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[1] *BT* Editorial, "The World of GAAP", *Business Today*, July 21, 2002, pp12.

Almost all the high profile failures are the result of the combined effect of failures in business, failures in governance and failures in reporting. The business issue that should be communicated to users of the financial statements is not properly disclosed, governance structures fail to prevent or detect this, and a reporting failure results. As an entity moves closer to business failure, the incentive to distort reporting increases and, therefore, the chance of reporting failure increases.[2]

Samuel A DiPiazzia, Jr, Chief Executive Officer of PricewaterhouseCoopers refers to the corporate reporting supply chain. "Management has a responsibility to be honest and direct and transparent, boards have a responsibility for oversight, auditors have a responsibility to investigate and provide assurance, analysts have a responsibility to be independent, media has a responsibility to report fairly and the investor has a responsibility to do his homework. We had failures all along the chain last year." [3]

The audit profession has found itself in an unenviable position because of a critical mismatch:

- The world views the audit profession as a bloodhound that is expected to hunt fraudsters and prevent all frauds;
- The audit profession views itself as more of a watchdog that can bark when burglars come its way.

Unfortunately for the profession, some blue-blooded auditors kept watching while the dogs ran away with shareholders' money in some high-profile corporate scandals.

Stephen Butler, Chairman of KPMG LLP has an interesting view. According to him, although audit failures are always high profile, only 1 in 10,000 audits is deemed substandard by regulators. "There will be plane crashes, no matter how sophisticated the equipment and pilots are." [4]

Weakening ethical structures in companies have put pressure on the auditor to assume a role that is more of a bloodhound, rather than merely that of a watchdog

Is there hope for the audit profession? Just as radar systems need to be proactive in tracking the developments in aviation technology, audit has to keep pace with developments in the corporate world. How can we build responsiveness and adaptability in a profession that is trained to review the past rather than look into the future? That is the big challenge. A review of the contours of change affecting the corporate world can help change the profession's perspective significantly. Let us review some of these changes.

Changing Ethics

Ethical structures in society have unfortunately weakened. This has affected the companies being audited, as well as the audit profession itself.

Weakening ethical structures in companies have put pressure on the auditor to assume a role that is more of a bloodhound, rather than merely that of a watchdog. In the United States, the Public Oversight Board's Panel on Audit Effectiveness went to the extent of suggesting in 2000 that auditors need to use forensic techniques in every audit, assume the possibility of management dishonesty, and incorporate an element of surprise into audits.[5]

The audit profession needs to recognize the change in expectations, gear itself to meet the higher responsibility level, and educate company boards, investors, stock exchanges and regulatory authorities on what can and cannot be expected from the audit.

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2 International Federation of Accountants, "Re-building Public Confidence in Financial Reporting", *Task Force Report*, 2003, pp11
3 Mythili Bhusnurmath, "Scam onus must be shared", *The Economic Times*, February 17, 2003.
4 Stephen Barr, "Breaking Up the Big 5", *CFO Magazine*, May 1, 2000.
5 Kris Frieswick, "How Audits Must Change: Auditors Face More Pressure to Find Fraud", CFO Magazine, July 01, 2003.

The profession has perhaps recognized the need for change and is preparing itself for the responsibilities. KPMG, for instance, added more than 300 "forensic professionals," including some who trained at the Federal Bureau of Investigation, who will take part in some routine audits. At one recent audit, KPMG ran all the addresses of a client's vendors to see if any of them matched a list of rental post office box addresses—a hallmark of a fictitious vendor. It found 17 addresses fitting that description. The firm is also launching a pilot program to conduct due-diligence-type reviews on certain audits.[6]

Arthur W Bowman, Editor of Bowman's Accounting Report has a interesting comment. "A good fraud will beat a good audit anytime." [7]

Greg Weaver, National Managing Partner for assurance at Deloitte Touché Tohmatsu says, "We're doing a test of assertions." But can auditors be sure results are reliable without testing for fraud? Auditors say it's not that they don't want to catch fraud, but since it's impossible to catch it 100% of the time, they shouldn't be held responsible if they miss it. "We get it right 98% of the time," says Weaver. "But to do 100% verification, you'd basically be recreating the records. There's no way that anyone could do that at a cost the public would consider acceptable."[8]

Education holds the key to ensure that auditors do not face the brunt of unreasonable expectations

Arthur Levitt Jr., the then chairman of the Securities Exchange Commission, said in 2000 that for the first time ever, the CEO of a Big Five firm, Jim Schiro (Head of PricewaterhouseCoopers), supported proposals to identify fraud, stating "forensic-type procedures on every audit to enhance the prospects of detecting material financial statement fraud is fundamentally sound and—I might add long overdue."[9]

Having seen the writing on the wall and taken some initial steps, the profession now needs to educate outsiders about its role, and the results that can be expected from such role. Education holds the key to ensure that auditors do not face the brunt of unreasonable expectations.

Weak ethics has also impacted the profession internally. Arthur Levitt Jr., deserves credit for his prescience in highlighting several years before the Enron scandal that consulting activities could compromise audit independence. He pointed out that audit services had dropped to about 33% of revenues at the major accounting firms, down from more than 50% a decade earlier. "I can't help but wonder what impact this changing business mix has had on a culture that has prided itself on objectivity."[10]

Against the backdrop of the corporate scandals, demands to ensure audit objectivity by keeping out consulting business were not unexpected. Limitations on taking up projects that would require auditors to audit their own work, act as advocates for clients, or take on a management role for clients are understandable. So also are the restrictions on investment activities of audit personnel and related parties. These, however, pose some unique challenges to keep the audit business model stable, as discussed later.

Changing Market Structures

The product markets as well as financial markets are globalizing at an unprecedented pace. This is happening in the physical as well as virtual spaces (Internet).

[6] ibid

[7] Steve Bergsman, "Loss-Leader or Client-Feeder?", *CFO Magazine*, September 28, 2000.

[8] Kris Frieswick, "How Audits Must Change: Auditors Face More Pressure to Find Fraud", *CFO Magazine*, July 01, 2003.

[9] Arthur Levitt, "The Public's Profession", www.sec.gov.

[10] Stephen Barr, "Accountants Head to Washington, DC", *CFO Magazine*, November 1, 2000.

The recent case of profit smoothing by Freddie Mac shows the extent of influence of financial markets on accounting. This No. 2 mortgage finance company in the United States has reported that it overstated earnings by almost $1 bn in 2001, and understated profits for 2002, 2000 and earlier periods by more than $6 bn. This raises the specter of legal claims by parties that traded on the basis of incorrect earnings. Auditors too can fall within the ambit of such claims.

In a speech to the Federation of Schools of Accountancy in Arlington, Virginia, in October 2001, Isaac Hunt Jr. opined "Markets are only viewed as safe and stable if investors trust and understand the underlying financial reporting structure ... The federal securities laws – to a significant extent – make accountants the 'gatekeepers' to the public securities markets ... Without an opinion from an independent auditor, a company cannot satisfy the statutory and regulatory requirements for audited financial statements and cannot sell its securities in the US markets".[11]

For markets to work, for the appropriate signals for efficient resource allocation to be provided, investors must have as much information as possible. There are inherent conflicts of interest: Owners and managers have a natural incentive to present a picture as rosy as possible. Auditing is intended to put limits on potential abuses. But who is to guard the guardians? Who is to audit the auditors?[12]

To address this issue, the Sarbanes-Oxley Act in the United States provided for creation of the Public Company Accounting Oversight Board (PCAOB). In India, the Naresh Chandra Committee has not favored such a Board. The Institute of Chartered Accountants of India (ICAI) prefers to strengthen the peer review system. Whatever the system, it is important that it works. Didn't Deloitte Touche Tohmatsu conduct a peer review on Arthur Andersen's audit of Enron?

Globalization of financial markets has put a premium on global accounting and audit standards

A related issue is the mismatch between the party that pays for the audit (existing shareholders) and the beneficiaries of the improved financial reporting (existing shareholders, prospective investors, stock exchanges and regulatory authorities). In internationally listed companies, the constituency of beneficiaries of the audit process can be several times larger than the constituency of parties that bear the audit cost.

There is no credible alternative that mitigates this paradox of most beneficiaries not paying for the audit. Can the stock exchanges bear audit expenses of all companies listed with them? Or can the government pay? Under these alternatives, is there a fear of audit becoming another bureaucratic activity? On what basis, for example, would the exchange prefer KPMG over Ernst & Young for one company, but opt for the reverse in another company? These are issues that need debate.

Globalization of financial markets has put a premium on global accounting and audit standards. A company whose business is restricted to India and whose securities are listed only in India can get away by complying with Indian accounting and audit standards alone. But international listing of securities necessitates preparation of financial statements and their reporting as per international standards.

Internationalization enhances the knowledge levels expected from auditors. Therefore, audit firms need to formalize joint ventures, or operate as informal communities of practice. The ability of audit firms to retain globalizing clients would be contingent on the firms moving proactively on this front.

[11] Stephen Taub, "Are You the Gatekeeper? SEC's Hunt Reminds Auditors of their Role", *CFO Magazine*, October 30, 2001.
[12] Joseph Stigilitz, "Crony Capitalism, US Style", *The Economic Times*, February 16, 2002.

Changing Company Structures

This has several dimensions:

- Globalization of product markets and cross-border business operations of companies have changed company structures. It is not uncommon today for an Indian company to have business interests in several countries. These may be structured as joint ventures, branch offices, subsidiaries etc. International alliances would help audit firms offer a complete service to their clients, or at least ensure that the audit process is backed by the requisite knowledge base.

- Special purpose entities and derivatives pose unique challenges on account of the infinite structuring options. Currently India adopts accounting standards that are initially developed abroad. Thereafter, the ICAI brings out a related accounting standard for India. The time gap between the international standard and Indian standard could be several years. The gap needs to be crashed, perhaps by making the international standard applicable until the Indian standard is developed. Further, both standards need to be based on similar principles. Auditors need to watch out for clients who may exploit temporary, unintended gaps in standards.

- The role of technology in business is increasing. From its initial role in gathering and disseminating information, the Internet has graduated into a facilitator of transactions. This has increased the risks that any company is exposed to. What is the appropriate agency to evaluate the risks? Auditors have been addressing these as part of their systems audit. The time has perhaps come for the profession to take a call on the limits to its competency. Like a good general practitioner who recommends a specialist when required, the auditors should take the benefit of specialists to audit the technology risks underlying systems audit. The government could perhaps mandate that qualified professionals (Certified Information Systems Auditors / Certified Information Security Manager) should be engaged for this aspect of the audit.

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- Apart from technology, businesses are exposed to several other risks. Auditors can increase their effectiveness by concentrating on the risks that fall within their areas of competency. For instance, could the Unit Trust of India fiasco have been controlled if the auditors had pointed out the mismatch between the promises to the investors and the underlying investment pattern; or the dangers of re-purchasing units at prices higher than the Net Asset Value (NAV)? Are these issues that an auditor would typically have considered? Probably not. Does the government and markets expect auditors to address such issues? Certainly yes.

- The role of internal audit in organizations too is increasing. An interesting example is that of Shoppers' Stop.

Ernst & Young, as internal auditor at Shoppers' Stop was involved in discussions on fashion trends and merchandising problems in Chennai and Jaipur. Chandrashekhar Navalkar, CFO, Shoppers' Stop explains "The fact that menswear is not doing well in these cities is a risk that will ultimately affect our business. That's why internal audit is involved".[13]

- Companies are seeking to become real-time enterprises where practically all the information flows are online. The audit process too has to move correspondingly fast. Thus, while their roles and responsibilities are increasing, auditors have lesser time available to do their work. Apart from greater thrust on systems audit (as distinct from audit of transactions), the audit profession needs to reengineer its processes and make better use of technology.

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[13] Radhika Dhawan, "The New Risk Managers", *Businessworld*, November 18, 2002, pp18.

- Corporate governance is emerging as a means to ensure balance in the interests of all stakeholders in companies. Compliance with corporate governance requirements is a new area where the statutory auditors' role will increase.

Changing Role of CFOs

My earlier writings on the subject ("CFOs: Changing Role", *Chartered Financial Analyst*, December 2002; and "Super CFOs: Competencies for Success", *ICFAI Reader*, April 2003) have covered this exhaustively. The implications for auditors are:

- CFOs are re-orienting their energies from financial reporting, to focus on the company's operations that need to be reported. A parallel re-orientation is expected of auditors to ensure that the operations are conducted transparently at an acceptable level of risk. Hence, the need for risk assessment approaches mentioned earlier.

- The role of CFOs in strategy formulation and implementation is increasing. This can lead to greater thrust on strategy audit and management audit in companies. Subject to issues of audit independence, auditors can make this a thrust area. Audit firms can offer these services to parties who are not their audit clients.

- Another change in CFO's activities, driven by the capital market, is the importance of forecasts. According to Michael Groom, President, Institute of Chartered Accountants of England & Wales, "there is currently no truly complementary process that addresses market pressure for forward looking information...We need a more disciplined and realistic information feed to investors in this area – a challenge of the assumptions underlying the forecasts and projections that companies announce."[14]

Accounting appears to be migrating from being cost-driven to valuation-driven

Accounting itself appears to be migrating from being historical cost-driven to valuation-driven. The trend is visible with so many companies opting for brand valuation, human resources valuation, embedded value, customer life cycle value etc.

According to Isaac Hunt Jr.,"In today's dynamic economy, investors have become increasingly interested in the fair value of a company's assets and liabilities, as well as historical cost information provided in financial statements.... Preparers, auditors, and even investors need to become more educated on fair-value estimates – how they are calculated, what they mean, and when they are used."[15]

For the audit profession that swears by accuracy of its work, projection and valuation are looming grey areas. But given the capital market implications, auditors need to put their thinking hats to determine how to audit the reasonableness of projections and valuations. A point to note is that auditors are not supposed to undertake valuation of items that would go into the financial accounts that they audit. Such conflict of interest situations need to be avoided.

- As the role of subjectivity in the audit process increases, the profession will find it difficult to make a clear choice between an "unqualified report" and a "qualified report" for the client. Auditors will need to conceptualize "audit ratings". Mr. Auditor, your client's borrowing program has been rated 'AAA'. What is the client's audit rating?

[14] International Federation of Accountants, "Corporate Governance—The Role of Financial Reporting and Auditing in Good Corporate Governance", Speech at the IOSCO Conference, May 2002.

[15] Stephen Taub, "Are You the Gatekeeper? SEC's Hunt Reminds Auditors of their Role", *CFO Magazine*, October 30, 2001.

The Audit Business Model

The audit equation is Capability + Objectivity = Credibility.

Alliances and knowledge management systems can address the capability issues. Ring fencing of consulting activities, and investment restrictions on audit personnel and their related parties, are meant to ensure objectivity. These text book solutions, and the overall thrust towards the role of a bloodhound, have led to three challenges that audit firms need to surmount:

- **The role challenge:** Barring isolated instances, auditors share a harmonious relationship with their clients. It is unfortunately difficult for a bloodhound to be friendly! Auditors will require significant people management skills to ensure that they perform the role expected of them, while maintaining the harmony in their client relationship.
- **The revenue challenge:** Audit is often viewed as a "loss leader" – a window through which other consulting services can be pushed to make the whole operation profitable. Audit independence issues have thrown a spanner on the consulting services. Where does that leave the firm?

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  Consulting income tends to be high but unpredictable. Audit fees were low in the past. But enhanced responsibilities have to be matched with higher fee. Therefore, although audit firms may not have the benefit of strong consulting income in future, they will also not be subject to its cyclicality. Audit will be a stable, moderate fee earning business.
- **The people challenge:** Performance of any profession depends on the quality of its people. Chartered accountants hold the key to the audit profession. The three broad career options for chartered accountants are to practice, or to join an organization in the accounts/finance department, or to join a financial services company. Given the job options and small firm economics, the proportion of chartered accountants who practice is decreasing.

Audit firms that fail the revenue challenge will find it extremely difficult to attract the right talent. Small firm practices may not survive independently, unless they can identify some exploitable niche of specialization.

The complexion of audit firms is likely to change. Enhanced responsibilities could lead to:

- Greater knowledge sharing within the firm and a trend towards taking a conscious "firm view" on most issues, in particular ambiguous issues. More the number of partners, greater would be the need for knowledge management systems that would facilitate this.
- Closer supervision of audit work within the firm, backed by detailed listing of audit processes.
- The organization structure of audit firms too may evolve. We may see the emergence of a stronger staff function. This would comprise people who offer better value in generating the "firm view" and/or who lack the requisite supervisory skill sets for the audit work.
- An independent monitoring role is likely to emerge within audit firms, to ensure the compliances inherent to audit. This role could be given the politically correct nomenclature of "audit quality assurance".

In India, the increase in responsibility level throws up a ticklish issue. Partnership firms operate on the principle of unlimited liability. Where does that leave other partners if one partner acts negligently? It is time for a new partnership act with facilitating provisions for 'Limited Liability Partnerships (LLPs)' of the type seen abroad.

Audit firms will also need to pay greater attention to the risk of third party claims. Insurance companies will target auditors with as much vigour as they target doctors. Some sort of grading of auditors based on track-record and systems too is not too far-fetched. The nature of the legal system would ensure that this change hits India much later than some of the other changes envisaged here.

Audit Firms in India

Inspired by General Agreements on Trade and Services (GATS), foreign firms will be permitted to set up offices in India or send in their international specialists to handle short-term assignments. Initially, the foreigners may be permitted to take up only non-statutory audit work. But it is only a question of time before full scale audit work is permitted.

Indian firms need to appreciate that ultimately, the client is the king. If the client prefers a global audit firm, then Indian firms cannot prevent the freedom of choice for long. So the Indian firms are well advised to prepare for such international competition, and concentrate their energies on seeking to exploit the opportunities that are likely to be opened out for them abroad.

Rediscover or Reinvent?

Where does the audit profession go from here? Abraham Briloff, Professor at Baruch College, City University of New York uses strong words. "I would like Pfizer to use all the insight it gathered in developing Viagra," he said, "to develop a drug that would stiffen the backbone of all those involved in the financial-reporting process."[16]

Arthur Levitt, in a speech to the Fall Council of the American Institute of Certified Public Accountants at Las Vegas, Nevada in October 2000 provided a thought provoking perspective to the auditors:

"As part of a private profession with a public mandate, you face unique pressures and challenges that, every day, demand your careful attention and impeccable judgment. And whether you are an accountant in a large firm, or a sole practitioner in a small town, every public accountant in America has been handed the same precious franchise, granted its special privileges, and charged with its care".

But it's a franchise that demands you to defend and protect, above all else, the public trust; a franchise that asks you to stand firm – even under the weight of management's pressure to "see things their way." But as those of you in this room well know, the role of the accountant is sublimely unique. The watchword of many in business is "the customer is always right." But in what other profession is it one's duty to tell the customer when he's wrong? What other profession is enshrined in our nation's securities laws to serve no interest but the public's? What other profession so directly holds the key to public confidence – the life force of our markets? [17]

The need of the hour is, for the audit profession to rediscover its ethics and reinvent itself to capitalize on the emerging new frontiers. ♦

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[16] Stephen Barr, "Breaking Up the Big 5", *CFO Magazine*, May 1, 2000.
[17] Arthur Levitt, "The Public's Profession", www.sec.gov.