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Audit Failures and Risk Alerts in an Age of Global Uncertainty

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As 2011 draws to a close, amidst global recession, amidst predictions about the breakdown of the Eurozoneand faltering growth rates even in China and India, opinion is divided across the world whether the global recession of 2008-09 is still continuing or whether the crisis triggered by the difficulties in Europe marks a new phase in global economic uncertainties. One does not really know the answer but the fact is that corporate failures, bank failures and systemic failuresare continuing as we step into an uncertain 2012.

While a large number of banks, mortgage business operations, insurance businesses, hedge funds are getting into difficulties, one question is increasingly engaging public attention. The question is – what were the auditors doing while these businesses fell like nine pins? There is very recent news that in Germany the nationalized mortgage bank, Hypo Real Estate has recently discovered an accounting error of € 55 billion after the auditwas over and the accounts containing such error were published. There is news that the Japanese camera maker Olympus has been hiding for two decades large losses relating to security investments. There is news that MF Global, the recently bankrupt Hedge Fund, as recently as May 2011 was given a clean chit by its auditors about its controls. There

is further news about more European financial sector entities, such as Austria's Erste Bank which was wrongly treating credit default swap contracts as financial guarantees and Dexia the French- Belgian lender which had to take a Govt. bailout but had been getting clean bills of health from its auditor.

As such news pours in and as people look back into the past to recollect major accounting scandals such as Satyam in India, Tyco International, Qwest Communications, Worldcom, Waste Management, etc., it is very obvious that the accounting and auditing profession is increasingly suffering from a credibility gap.Such credibility gap is best described in the language of The Economist which in an article published in April, 2003 described current models of financial reporting as producing little more than a "brittle illusion of accounting exactitude". Of course the auditing profession prefers to call this the expectation gap which is defined as the perceived difference between what the auditors are expected to accomplish and what the auditor himself believes that he must accomplish.

Whatever may be the tag put on the gap in auditors' performance there is also the reality of increasing litigation and adverse regulatory findings. In the Bankruptcy Examiner's report in connection with the failure of Lehman Brothers it was found that a "colourable claim of professional malpractice exists against Ernst & Young" . There is recent news that the regulators in the U.S have subpoenaed PWC in connection with the collapse of MF

Global. There is also news that the Accountancy &Actuarial Discipline Board in the United Kingdom has been carrying out investigation in connection with the audits done by KPMG of British Aerospace / BAE Systems. The special investigator appointed by the Institute of Chartered Accountants in Ireland to look into the collapse of the Anglo Irish bank has also issued a statement that there is a prima facie case that Ernst & Young needs to answer various points which are under enquiry. Litigation has been brought against PWC by the investors in the case of the bailed out insurer AIG and also by the bankruptcy trustee of Refco Inc. a failed futures broker, in which damages are being sought from the auditors of Refco Inc. There is also news coming in that the auditors of numerous funds which invested money with Bernie Madoff are being questioned as to why they did not raise the red flag in respect of these investments. In Iceland an Icelandic prosecutor commissioned group of investigators has found an audit failure committed by PWC in the audit of two Icelandic banks. There have also been recent reports that the PCAOB which inspects auditors of various listed companies in the USA has been finding an increasing number of failures including errors that are likely to be material to the issuer's financial statements.

It is quite obvious that as the world goes through economic volatility, as sovereign nations slip into debt traps, as currencies fluctuate sharply, the risks emanating from the environment are becoming greater. Such risks inevitably create business failures which, in turn, bring the auditors into

the limelight and create increasing pressure on the auditing profession to find defences against charges of culpability.

The answer to this situation is for the auditing profession to understand the changes that are taking place in the environment, in the methods of financial reporting, in the practices of risk assessment and finding methods of addressing uncertainties.

While the issue of audit risks and Risk Alerts will be dealt with in greater detail later, it will be useful to spend a little time discussing the changes in financial reporting and audit practice. An excellent report produced by the Chartered Accountants of England and Wales in the year 2009 has identified major changes in the practices of financial reporting. These changes are: –

- Changes in financial reporting standards and the increasing importance and the rigor of standards. Some of the changes have been driven by what has been learned from periodic crises and scandals but much of the change stems from the increasingly complex transactions and businesses which financial reporting has been required to describe, particularly for the largest companies. Standards are being issued to tackle acknowledged problem areas including off balance sheet finance, capital instruments, mergers and acquisitions, goodwill and asset impairments and provisioning. While still being ‘principle-based’, the style of the standards changed as they moved

from being relatively brief, high-level guidance to beingmore rigorous standards that were more comprehensive and more detailed.

- Changes in the conceptual framework of the financial reporting standards which increase the uncertainty attached to financial statements. Many financial reporting standards now being issued treat relevance as a primary qualitative characteristic of financial reporting information and downplay reliability, thus leading to greater uncertainty. In their conceptual frameworks, accounting standard setters have articulated an objective for financial reporting, which is to supply information to the providers of risk capital that will help them assess prospects for future cash flows. This has been perceived as a move away from the notion of financial statements as a statement of stewardship of the business that shows how directors or managers have discharged their responsibility to providers of risk capital in providing a return for the past period. Financial reporting standard setters are increasingly seen as placing greater emphasis on the*relevance* of financial reporting information for decision-making by risk capital providers. Previously, financial reporting was seen as involving a trade-off between *relevance* and*reliability*, with reliability being a characteristic that reduced the risk to preparers and auditorsof information turning out to have been erroneous. However, the IASB has been working withthe US Financial Accounting Standards Board (FASB) on a new conceptual framework whichsignals a change of emphasis. For some people, this means that financial statements

willincreasingly contain information that is not capable of being audited in the same way thatother, more traditional elements of financial statements are. This information relates more tothe future than the past and is increasingly derived more from expectations and currentvalues than from historical transactions.

- Greater use of current values and fair values as a basis of measurement in order to give information that is considered relevant to users of financial statements. The vast majority of assets and liabilities in the vast majority of financial statements are still shown at amounts based on historical cost. However, for certain types of entity, particularly financial institutions, current or fair value is applied to a substantial part of their balance sheets. Auditors are by default giving assurance over future-oriented information and thereby giving users of accounts, who tend to be forward looking, assurance which is more aligned with their interests.

These changes in financial reporting practices have forced auditors to re-evaluate the auditing standards and methodologies.

Auditing standards have developed in two ways to tackle uncertainty and potential variabilityof economic outcomes. Firstly, there is a much greater focus on audit risk, so that more workis done during audit planning to assess those areas that require most attention. The extent to which any

particularelement of the financial statements involves significant judgement because of its uncertaintyor potential variability will be a factor in the audit risk analysis. Secondly, auditing standardsetters have developed auditing standards about specific financial reporting items that aresubject to audit and provided more detailed guidance on certain aspects of financialreporting.

The issue of assessing risks in auditing has been the subject matter of various international pronouncements. The International Standard on Auditing 315 deals in detail with identifying and assessing the risks of material misstatement through understanding the entity and its environment. It lays down detailed procedures for risk assessment procedures and related activities. It outlines steps for the required understanding of the entity and its environment including the entity’s internal control and it also spells out the steps in assessing the risk of material misstatement.

The issue of Risk Alerts arises from the concept of audit risks. The Risk Alerts utilize the term Engagement Risk in describing various risks auditors consider in performing an engagement. Engagement risk encompasses risks borne by both the auditor and the client entity.Engagement risk represents the overall risk associated with an audit engagement. Engagement risk consists of three components: client's business risk (also referred to as entity's business risk), audit risk, and auditor's business risk.

An entity's business risk is the risk associated with the entity's survival and profitability. In contrast to entity's business risk, audit risk is the risk that the auditor may unknowingly fail to appropriately modify the opinion on financial statements that are materially misstated.The concept of auditor's business risk is in addition to audit risk. This risk arises from the fact that the auditor is exposed to loss or injury to his professional practice from litigation, adverse publicity, or other events arising in connection with financial statements that he has examined and reported on.

The concept of Audit Risk Alerts arises from the importance of audit risks in carrying out an audit. Audit Risk Alerts provide auditors of financial statements with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. Updated annually, alerts also help identify the significant business risks that may result in the material misstatement of a client’s financial statements. Audit Risk Alerts also can be used by an entity’s internal management to address areas of audit concern.

Audit Risk Alerts could be issued on a national level or could be issued for specific industries such as the building industry, the banking industry, insurance industry, etc. In the United States such Risk Alerts have been issued for employee benefit plans industry, financial institutions industry, health care industry, investment companies industry, life and health

insurance industry, not for profit entities industry, property and liability insurance industry, real estate and construction industry, service organisations, etc. Normally Audit Risk Alerts cover areas in respect of which risk assessments have to be done as these areas could be sources of major risks of financial misstatement. For example: the AICPA has issued Audit Risk Alert for the year 2011-12 covering the following areas:

- Business combinations
- Troubled Debt Restructuring
- Disclosures about credit quality and Allowances for Loan Losses
- Embedded credit derivatives
- Fair Value Measurements
- Goodwill impairment test
- Milestone method of revenue recognition
- Modification of loans within a pool
- Multiple deliverable revenue arrangements
- Share based payment awards
- Software elements

It is obvious that all the above represent complex business transactions or use of financial instruments or use of estimates which could lead to major uncertainty. These Risk Alerts issued in the year 2011-12 represent concerns about possible areas of financial misstatement in a post global meltdown era. However, depending on the time and the country and the

context these Risk Alerts would change. For example, in the year 2000 the U.S. Securities and Exchange Commission issued Audit Risk Alert to the AICPA which had as major issues: –

- Amortisation of major advertising costs
- Appropriate classification of accounts within the income statement and the balance sheet.
- Disclosures of the impact of recently issued accounting standards
- Treatment of intangible assets arising out of business combinations
- Employee pension and other postretirement plan disclosures
- Segment disclosures
- Allowance for loan losses
- Revenue recognition
- Income Tax shelters
- Stock compensation
- Accounting for convertible securities with beneficial conversion features
- Documentation and disclosure related to derivative instruments and hedging activities
- Financial instruments and derivative contract terms
- Equity method of accounting for investments in common stock
- Changes in accounting policy
- Foreign currency transactions, etc.

It is seen that the focus on Audit Risk Alert has changed significantly from 2000 to 2012 and items such as troubled debt restructuring, fair value measurements are new features in the Risk Alert.

The use of Risk Alertas an innovative audit tool to assess audit risks is now fairly widespread. In India regulators for banking and insurance industries issue prudential norms which draw attention to desired accounting treatment in specific areas such as restructuring of troubled loans, derivative losses, etc. Quite often auditors with clients operating across borders issue Risk Alerts to their counterparts in other countries for the specific client. These Risk Alerts draw attention to specific transactions or specific accounting treatments which could pose potential risks in the audit of the particular client.The Big Four firms use Risk Alerts to better equip themselves to assess audit risks. This could be a tool to be used by international networks to alert member firms about developments in the economy or, developments in specific industries, which can be areas for audit risk. These Risk Alerts need to be updated periodically, preferably on an annual basis, to draw attention to new national and international developments and also to specific industry phenomena.

As auditing moves more into exercising judgment on assumptions made in financial statements there is a distinct move in auditing from assessing historical data to assessing evidence relating to probabilities. Risk Alerts play a very vital role in this paradigm shift in the audit profession.