The findings of the Royal Commission into the collapse of HIH.

1. Introduction

In February 2003, the hearings of the Royal Commission into the collapse of HIH Insurance drew to a close. The matters heard before the Royal Commission are many and complex and for this reason the Royal Commission's reporting date has been extended to 4 April 2003. The reporting date of the Royal Commission was previously extended to 28 February 2003. This later extension of the reporting date will further delay the publication of the government's final reforms on auditing and financial reporting.

One important matter heard in January 2003 hearings of the Royal Commission was the final submissions of the Counsel Assisting the Royal Commission. These submissions are similar to the prosecutor's final remarks in a criminal case brought before the courts. The final submissions are said to make reference to "more than 1,000 breaches of the law by managements of FAI, HIH and their advisors…". (Main, 2003, p.8) The submissions guide the Royal Commissioner in compiling his final report, with the contents of the final report being the sole responsibility of the Royal Commissioner.

2 Audit methodologies

An important matter raised by Counsel Assisting related to Arthur Andersen's methodology used to collect evidence in the HIH Insurance audit. Being the crux of an audit, evidence issues are generally the main means that courts judge auditor negligence. The relative worth of evidence, reporting and independence was discussed in November 2002's edition of *Current Affairs in Auditing,* and you should review this material before reading this month's edition.

A good way to reconsider this material is to discuss the objective of a financial statement audit outlined on page 30 of Gill *et al.* (2001). This states that the objective of a financial statement audit is "to express an opinion … (after) … collecting and evaluating evidence about an entity's financial affairs so as to establish the degree of correspondence between the management's assertions and established criteria…" In collecting and evaluating evidence and providing the opinion the auditor should act in an independent manner. This indicates that the concept of independence is secondary to evidence and reporting, and is relevant to the extent that it explains the adequacy of the auditor's evidence procedures and reporting functions of the auditor.

3. Criticisms of audit methodology adopted in the audit of HIH Insurance

An article published by Ravlic (2003, p.14) details the claims made by Supporting Counsel relating to the deficiencies of the Arthur Andersen audit of HIH Insurance. As this edition of *Current Affairs in Auditing* is discussing audit methodologies, the criticisms relating to the Arthur Andersen's audit methodology will only be reported.

The Ravlic article stated that Arthur Andersen changed the way it conducted audits in 1999 to an audit approach called *Business Audit Process,* which focused on reviewing client risk-management systems.

Ravlic states that submissions by Counsel Assisting the Royal Commission

- infer that the new methodology was introduced to reduce costs and increase profitability of audits; and

- state that the methodology results in less transaction data being tested, which could increase the likelihood of error in financial statements (p.14).

4. Discussion of new methodologies

Jeppeson (1998) notes these methodologies were introduced in the 1990s and Ernst & Young, Arthur Andersen, Deloittes and the then Price Waterhouse seemed to have adopted these forms of methodologies (p.525).

5. Traditional Audit methodologies

In general, audit methodologies include the following.

- A planning stage that gains information to understand the auditee's business;
- Assessment of risk ascertaining if risk could cause account balances to be materially misstated;
- Testing of transaction data through tests of controls and substantive tests;
- Testing of balances included in financial statements through tests of controls and substantive tests; and
- A review of the reasonableness of contents of profit and loss and balance sheet.

To understand audit methodologies it is instructive to discuss this topic in relation to the debtors control shown below.

Debtors Control

Sales	10,000,000	Cash receipts	7,000,000
		Sales returns	2,500,000
		Balance	500,000
	10,000,000		10,000,000

The transactions comprising the total sales, cash receipts and sales return figures will be tested to ensure the transactions are accurate, complete and authorised. In effect the auditing is testing the transaction data that

- is included in the Profit and Loss; and

- leads to the calculation of the final debtors balance of $500,000.

After year-end, the auditor would test the individual debtors that comprise the closing balance of debtors to ensure that the debtors figure of $500,000 adheres to all financial assertions listed in *AUS 502: Audit Evidence*. In all stages of the audit process, as listed above, the auditor would wish to gain information that indicates potential audit problems. Risk evaluation is an obvious example of this point. In the above illustration sales returns at 25 percent of sales are high. This suggests a faulty and unsaleable product exists. If this is true, this could suggest poor net sales, low profits, poor cash flow, build up of obsolete stock and fixed assets relating to the manufacture of this stock may be obsolete. Debtors may be overstated as a portion of the current debtors may result from the sale of the defective product and be subject to a credit claim. The poor cash flow could lead to non-payment of liabilities that may lead to the winding up of the company. The above emphasises that problems in one part of the audit can have serious impact on other parts of the audit and the auditor should gain a total understanding of the firm and the significant events that affect the published results to conduct an effective audit.

6. Description of new methodologies

As much information about KPMG's audit methodology is available on the internet, this section will base the description of the new methodologies around KPMG's methodology, called Business Measurement Process (BMP). The prime document used in this description is entitled *KPMG's Risk-Based Audit* (2003), and was included under the Financial Statement Audit section of KPMG's International website. This suggests that the BMP methodology is used for KPMG statutory audits. However, the degree to which BMP comprises the KMPG audit methodology is uncertain. The book, *Case Studies in Strategic-Systems Auditing* (2002) is *published* by KPMG and University of Illinois at Urbana-Champion Business Measurement Case Development and Research Program describes and contains case studies dealing with BMP. However, included in the text on page iii is the following disclaimer.

> This book is not intended to constitute an exhaustive coverage of all policies and procedures comprising KPMG's full audit process, and how it comports with generally accepted auditing standards.

For the best discussion giving an overview of BMP you should read pages 3-34 of the book *Case Studies in Strategic-Systems Auditing* (2002). This book is available on the Internet and you can obtain the internet address from the list of readings.

KPMG's Risk-Based Audit (2003) states that there are rapid and dramatic changes in the business world that cause increasingly complex risks. Consequently an audit approach is developed that

- determines how risks impact on an organization's business performance;
- determines key risks after examining business market environment and industry;
- provides a framework for examining financial and non-financial flows that impact on financial statements;
- identifies opportunities for improving auditee's financial performance; and
- is industry focused that enables the auditor to identify high risk areas to an auditee's financial statements.

It is argued that currently sophisticated EDP processing systems would minimise error in processing transactions. Consequently, it is further argued that traditional audit methodologies that sample transactions and account balance details are less efficient and effective (Bell *et al*., 2002, p.3) BMP is a top-down audit approach and is said to be a superior audit approach as it focuses on how risk affects the business. After examining the risks confronting the business, and designing follow on tests of controls and financial statement amounts and disclosures (p.4), the auditor determines expectations about the financial results. These expectations are compared to actual results and if there are no significant deviations this provides evidence that the results contained in financial statements are reliable (p.10).

If there are deviations, the auditor develops detailed audit tests to determine why. After finding the source of the deviations the auditor either

- adjusts their mental model of the business; or
- has located misstatements that would be adjusted by the company; or result in an audit qualification (p.13).

For an auditor to give an unqualified audit opinion they would continuously examine deviations between their expectations derived from the mental model to the actual results until there is no significant deviation between the two (p.25).

7. Queries relating to methodologies

The information used to describe the new audit methodologies is just broad summaries of the operations of the methodologies. For a full understanding of any audit methodology vast documentation would have to be examined. Consequently, you cannot be certain about the strengths and weaknesses of the methodologies and any reservations about the methodologies have to be expressed as queries or possible problems with the methodologies. It would be left to bodies such as the HIH Royal Commission, who after reviewing in detail the application of the methodology to HIH's audit, to reach conclusions about the adequacy of these methodologies.

a. Associated with a period of high criticism to auditing

The introduction of these methodologies in the 1990s preceded a period of high criticism of the auditing profession. Arthur Andersen's methodology used in the audit of HIH Insurance would also be used for the audits of Enron and WorldCom. In USA, the woes of auditors increased when in January 2003, PriceWaterhouse was sued for its alleged negligence of the Tyco audit (Van Voris, 2003, p.27) Also, the Security and Exchange Commission filed a civil fraud complaint against KPMG for its audit of Xerox, alleging fraudulent conduct of the audit (Norris, 2003, p.1). As these charges allege fraudulent conduct of KPMG, these charges if proven, would cause considerable damage to the credibility of the auditing profession. For further details of the lawsuit you should read the Norris (2003) article.

In the last two years there has been widespread criticism of the effectiveness of an audit, with independence being the issue receiving the most attention. Given the importance of evidence collection, an investigation whether evidence collection procedures adopted by auditors result in sufficient, reliable and appropriate evidence should be undertaken. Failure to do so, would mean the area where auditors devote their majority of their work effort is overlooked in the current debate whether auditors are fulfilling their function of adding credibility to published financial reports.

b. Decrease in scope of audits and level of testing

The Panel of Audit Effectiveness (2000) conducted a detailed investigation into auditing in USA and their conclusions about the amount of testing arising with the introduction of the new methodologies concurred with Counsel Assisting the Royal Commission. The Panel stated that

> (t)he Panel's perspective is that, even in the face of the strengthened auditing standards issued over the past 15 or so years, audit firms may have reduced the scope of audits and level of testing, at least in part as a result of redesigning their audit methodologies (para 3.29).

For the then big 5 audit firms, the *Panel of Audit Effectiveness* (2000) describes the following characteristics of cases involving SEC Accounting and Auditing Enforcement Releases (AAERs). These characteristics, or areas where audit deficiencies occurred, seem to be a consequence of reduced scope of audits and level of testing occurring through the adoption of the new audit methodologies. These characteristics

> … included entities using information technology to facilitate the frauds, … management override of controls, material frauds at relatively small divisions or subsidiaries that the auditors did not visit, inadequate substantive tests…(para 3.42).

c. Do audit staff have skills to successfully carry out the new methodologies?

In addition to characteristics noted above, the *Panel of Audit Effectiveness* also identified another common characteristic of the cases as

> …audit engagement personnel not appearing to have adequate training, experience or supervision (para 3.42).

The audit staff who actually collect evidence tend to be recent graduates (Seville *et al*., p.2) and it is questionable they have the skills and experience to successfully carry the necessary procedures required by these new audit methodologies.

d. Do they result in predictable audits?

These new methodologies may result in a predictable audit as they adopt a top-down approach, with

- limited testing of transaction data; and
- reliance of analytical procedures to confirm or dispel whether actual results confirm to the auditor's mental model of the auditee's results (Bell *et al*., 2002, p.32).

The lack of emphasis of testing transaction data allows management the ability to manipulate results without auditors detecting these misstatements. This predictability is enhanced as the client is involved in choosing areas or processes to be audited (Jeppesen, 1998, p.526). *The Panel of Audit Effectiveness*, 2000, argues that unpredictability of an audit process is an advantage (p.90). Traditional audit methodologies are a mixture of top-down and bottom up approaches and this mixture results in a less predictable audit.

The *Panel of Audit Effectiveness,* 2000*,* provides evidence consistent with the proposition that these top-down methodologies allow management manipulation of certain transaction data knowing that the auditor's scrutiny of this data will be minimal. The first type of transaction data discussed is non-standard entries, a well-known source of transaction data used to manipulate results. Reference to such type of transactions is made in appendix 2 of *AUS 210, Irregularities, Including Fraud, Other Illegal Acts and Errors,* indicating auditors should be wary of these types of transactions. This appendix is entitled *Examples of Conditions or Events which Create the Risk of Irregularities*. The Panel's conclusions on non-standard entries are as follows.

> The QPR[i] disclosed that in about 15% of the engagements the auditors did not have an adequate understanding of the client's system for preparing, processing and approving non-standard entries. Furthermore, in about 31% of the engagements reviewed, the auditors did not perform procedures to identify and review non-standard entries, whether made at the end of the period or at other times (para 3.34).

The Panel's conclusions relating to SEC AAERs involving the then big 5's auditors also indicate that fraudsters may have been exploiting the lack of detailed examination of revenue transaction data.

> Most of the misstatements involved relatively routine accounts and transactions as opposed to complex judgmental areas and more esoteric accounts …Approximately 70% of the cases involved the overstatement of revenue – resulting from either premature revenue recognition or fictitious revenue (para 3.40).

In regard to analytical procedures, these new methodologies rely on establishing a mental model of the company and predominately use analytical procedures as a source of evidence to confirm or dispel whether their mental model of the auditee's results are accurate or inaccurate. The Panel notes that fraudsters can also exploit this reliance on analytical procedures as a source of evidence. The Panel states

> (t)he entities with the most sophisticated frauds often were concerned about concealing them from the auditors and particularly about making the numbers and the relationships among them "look right" to the auditors when they performed their analytical procedures. A favorite technique for accomplishing this was to "play around" with the numbers, often through the use of non-standard entries, until they "looked right." (para 3.41)

In July 2002 edition of *Current Affairs in Auditing* it was stated that manipulating figures so they appear reasonable to the auditor may have occurred in WorldCom's case. See this edition for more details of this case.

At this stage, the question could be posed whether these new methodologies comply with the auditing standards? The auditing standards are subjective; yet still give broad guidance on the conduct on an audit. For example, the auditing standards states in para .16 of *AUS 502: Audit Evidence* that greater confidence in the quality of financial statements is obtained when evidence obtained from different sources are consistent. The question arises do these new methodologies that concentrate on top-down evidence collection procedures satisfy the sentiments of this paragraph of the auditing standards?

e. Are they disguised consulting services?

As noted in our discussion of the new audit methodologies, one objective of KPMG's BMP audit methodology is that the auditors work with the client to identify opportunities for improving financial performance. Jeppeson (1998) argues that in adopting this methodology the "client" becomes corporate management rather than the users of financial statements (p.518). He further argues that the methodologies break down the barriers of consulting and auditing (p.518) and this negatively impinges upon auditor's independence.

f. Data base of risks and frauds

For the risk-based methodologies to provide the basis of an effective audit profession there is the need for an up-to-date database of risks that includes frauds. Risks are continually changing and evolving, and individual auditors need this database to ensure their knowledge of risks is current. Fraud is one form of risk and the *Panel of Audit Effectiveness*, 2000, recommend a comprehensive database be developed and maintained on fraud (p.94).

8. Auditing standards having statutory backing

The government in its recommendations in CLERP 9 have suggested that core auditing standards be given legislative backing (p.27) Legislative backing of auditing standards are said to improve ASIC's ability to enforce these standards (p.27). The profession has opposed this recommendation arguing that the subjectivity in these standards imposes problems of enforceability (Fabro *et al*., 2002, p.4).

There does seem to be inconsistent rhetoric in auditing/accounting profession when discussing principle-based standards, and their resultant subjectivity. Principle-based standards are said to be needed for statutory backed accounting standards. There would be no doubt much subjectivity involved in enforcing these standards. Yet subjectivity is said to be the reason why auditing standards that also relies on principle-based rules should not have statutory backing.

However, as we cannot observe auditor's evidence collection procedures and there is a fear that auditors are adopting the new methodologies that have weaknesses, auditors have to be reminded that their audits must adhere to the principles outlined in the auditing standards. Statutory enforceable auditing standards may be the best option to achieve this objective. Also, out-of-court settlements are preventing details of breaches of standards being publicised and also preventing appropriate remedial action being taken. Statutory backing of auditing standards will make it easier for the ASIC to initiate appropriate action against negligent auditors and allow details of their shortcomings to be publicly available. Once these shortcomings are remedied a stronger audit profession will result.

Conclusion

In this month's *Current Affairs in Auditing* we have discussed the new audit methodologies used by the large auditing firms. The importance of evidence collection in auditing is paramount and it is regrettable that the current debate about an "audit crisis" has neglected the important issue of evidence collection. This is the means how auditors compile their report and is the main reason why auditors may be held negligent by courts of law.

Because we cannot observe auditor's evidence collection procedures, we cannot be sure, at present, to what degree these new methodologies constitute auditor's evidential collection procedures. However given the timing of the introduction of these methodologies and the great criticism and public investigation of the auditing profession it is suggested the worth of the methodologies should be investigated. It is hoped that the final report of the HIH Royal Commission may comment on the worth of these methodologies.

This edition has raised some queries of the new methodologies, which it is believed should warrant investigation. The main fear is that the new methodologies result in a predictable audit, with limited testing of transaction data allowing management to seed fraudulent transaction data to boost operating results. Other fears are that audit staff may not have the skills to effectively implement the methodologies. Also the new methodologies may result in reduced time and less testing of transaction data leading to ineffective audits. Finally, a database of risks, that include fraud, is necessary for the operation of these new methodologies.

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ENDNOTES

[i] In 1999, the Quasi Review Process reviewed the effectiveness of audits of the largest eight audit firms in USA.