ICAA issues paper discussing the scope of the audit

This month's edition of *Current Affairs in Auditing* deals with the Institute of Chartered Accountants in Australia (ICAA) issue of a paper discussing the extent and scope of the audit. This paper raises a series of very important issues, and can be argued to be necessary for the auditing profession to maintain credibility in today's society.

Extension of the scope of the audit

In the March 2003 edition of *Current Affairs in Auditing* we noted Mautz comment on the need for professional groups to modify their role when confronted with change in societal conditions or needs. This point is of such importance that it is worthwhile repeating. Mautz stated that

> society either accepts or rejects the role that a professional group assumes for itself; in time the group either finds a role acceptable to society or the group disappears. As conditions and apparent needs change, society may reject roles formerly considered acceptable so professional groups must continually be alert to the desirability of role modification and revision (as quoted in Flint, 1988 p.16).

The applicability of the Mautz comment to the present situation confronting the audit profession is evident when, in June 2003, the ICAA issued a discussion paper relating to extending the scope of the audit. The paper is entitled *Financial Report Audit: Meeting the Market Expectations.* The paper was prepared by Professor Ken Trotman, Professor in Accounting at the University of New South Wales and is designed to generate debate about extending the scope of the audit function (p.2).

The paper recognises that public confidence in the independent audit function is an important principle underpinning capital markets (p.2) and attempts to reduce the audit expectation gap by educating the public have failed (p.3). Thus it is reasoned there is a need to expand the scope of the audit to meet market expectations (p.2). The areas where the scope could be expanded are categorised as

1. Being core audit services that include internal control, fraud and evaluation of going concern.

2. Extended audit services – business risks, management discussion and analysis, quality of accounting policies, corporate governance, continuous disclosure, performance audits and continuous audits.

The scope of the audit will be extended with core audit activities as soon as feasible, while the extended audit services may be introduced later.

The paper envisages that the introduction of these services is contingent upon the reforms to legal liability of auditors that includes

- reform of the doctrine of joint and several liability to proportionate liability
- incorporation of audit firms
- the introduction of a safety ceiling or safety capping (p.4).

The justification for

> (t)hese changes, taken as a whole, will provide more certainty for consumers, the insurance industry and auditors alike. Once greater certainty is back in the market and steps are also taken to address the culture of litigation, auditors will be prepared to extend the range of skills they have into new areas requiring assurance. Without these changes, few auditors are likely to undertake an expanded role. In the present legal environment they will not be prepared to go beyond the legal minimum in expressing an opinion on the client's financial statements (p.4).

In the March edition of *Current Affairs in Auditing* it was suggested that the director's responsibilities for preparation of the Financial Reports was increasing, with the importance of the auditor's role decreasing. It is submitted that the ICAA's suggestions for extending the audit scope accompanied by their desired legal reforms will have little impact on these trends. This is because the desired legal reforms will mean that auditors only pay a fraction of the loss caused by corporate collapse or fraud and liquidators will have to consider suing directors to recover more funds. Also, as Bartholomeucz (2003) notes in discussing the judgement against John Elliott for being guilty of allowing Water Wheel to trade while insolvent

> (t)here doesn't appear to be any new law in the Water Wheel case but it does conform to the broader trends within the courts and the community that place an increasing responsibility – some would say an ever-increasing responsibility – on non-executive directors to actively discharge their duties (p.3).

The significance of these changes, if implemented, is that the areas where an auditor can be sued increases, but damages awarded against auditors for negligence decreases. However, given that most auditing cases are settled out-of-court, there may not be that great a difference between damages awarded and payments made settling audit cases.

Audit expectation gap and auditor's role

Presently the courts decide if an individual auditor has displayed reasonable care and skill. As reasonable care and skill is evolving there is always uncertainty about the exact nature of auditor's duties. For example, auditors have some responsibilities to detect fraud and evaluate whether a company is a going concern, but it is difficult to determine where those duties end.

The vagueness of auditor's duties can act as an advantage to the auditing profession when discussing fault for failure to detect fraud and warning if companies are not a going concern. Power (1997) acknowledges the vagueness of defining auditor's duties when he

states there is an absence of output criteria to measure performance in auditing (p.27). He adds that auditors have "obfuscated the issue of what auditors really do and this lies at the heart of the expectation gap" (p.27). Once criticised, the auditing profession can invoke the expectation gap argument, stating that the areas criticised are part of the expectation gap and not part of reasonable practice (p.30). Because both parties to the argument have different conceptions of auditor's duties, the success or failure of the auditing profession becomes an "adversarial dispute in which questions of blame are at stake" (p.31). These disputes tend to be both never ending and futile. The existence of out-of-court settlements sustains these disputes because courts often do not issue judgements that give guidance on auditor's responsibilities.

Business failure and audit failure

An interesting proposal is for the ICAA to compile data on business failure and audit failure. Given the importance of this issue the relevant paragraph from the discussion document is quoted in full.

> It is important to continue to point out that the number of business failures in audited companies is small, and in business failures there is often no evidence of audit failure. However, there is no systematic evidence on exactly how small this percentage is and what was the cause of any audit failures. Such evidence would be useful in addressing whether suggested remedies for audit failure would be cost efficient. We suggest that the ICAA consider developing a list of corporate failures over the last ten years and for each of these determine from publicly available information (or possibly confidential information from the audit firms) when there were audit failures and the cause of these particular audit failures. How often have there been findings against auditors? How often have auditors been cleared? How often has the issue been settled out of court? The profession has continued to argue that there is no evidence that there has been a systemic failure in either audit independence or audit quality. This argument will be far more convincing if there was empirical evidence on the extent of audit failures (p.14).

Some comments on the thoughts expressed in the above paragraph are now given.

Firstly, audit failure is not solely associated with failed companies. If we define audit failure as a failure to conduct an audit according to the court's concept of reasonable care and skill, a bad audit can be conducted on a financially healthy company. For example, a bad audit can be conducted where the auditor for a highly material balance sheet assertion relies on verbal evidence or where inconclusive comments are left on workpapers. These audit failings can occur in the audit of a healthy company. Due to the confidential nature of an audit, these facts will never become public for an audit of a financial, healthy company. The above suggestion fails to document instances of the above examples of audit failure.

Secondly, it is suggested that audit firms would provide little cooperation in providing details of audits of collapsed companies. Except for high profile cases such as HIH Insurance and Harris Scarfe, for cases that may be settled it is suggested there would be little publicly available information on the conduct of an audit of a failed company. This is because the audit process is confidential and in settlements auditors deny negligence. The issue of audit failure, or whether the auditor conducted the audit showing reasonable care and skill, is never tested.

The necessity for some record of audit failures lies in out-of-court settlements. If these cases were subject to a court judgement, a record of audit failure or non-failure immediately occurs. The author in a paper on out-of-court settlements has considered the question on audit failure involved in audit where legal proceedings have been resolved in a settlement and has suggested the following. From the statement of claim and defence documents the ASIC could compile a summary of issues. An annual report summarising these issues could be published by the ASIC, allowing researchers to investigate the issues involved. It is realised that the above suggestion taxes the over-stretched resources of the ASIC.

Commentary on core areas where scope is extended

Due to constraints on time and space, we shall only discuss the recommended extension of duties to core audit services. For details of extension of duties for non-core audit services you should read a copy of the paper that can be obtained from the ICAA website.

Internal control

The paper notes there is an expectation that auditors do and should evaluate the effectiveness of internal controls. The paper notes various bodies such as the *The Joint Standing Committee on Public Accountant and Audit's Report, 2002* (Charles Report) and Institute of Chartered Accountants in England and Wales have dealt with this matter (p.6). The Sarbanes-Oxley Act requires annual reports to contain an assessment on the effectiveness of the internal controls relating to the issue of financial reports. The Act further states that as part of the audit, the auditor attests to the assertions made by management in the above assessment. On this section, the paper concludes there is growing demand for reporting on internal controls and the report is subject to audit (p.6).

The paper states, "to some extent this service has been unbundled in recent years" (p.6). Unbundling means that services on internal control cease to be part of the audit and are prided as a separate service. We have noted in prior editions of *Current Affairs in Auditing* that anecdotal evidence suggests that auditors place less reliance on internal controls in their revised audit methodologies. The demand for reporting on internal controls plus the requirements of the Sarbanes-Oxley Act suggests this was not a wise strategy.

Detection of fraud

This issue was discussed in last month's edition of *Current Affairs in Auditing* where it was suggested that auditors in the USA were assuming greater responsibility for the detection of fraud. Given that reasonable care and skill is evolving and reflects society's demands, it was also argued that courts would expect these assumed responsibilities to be part of normal auditing duties.

The paper notes the Panel of Audit Effectiveness comments stating that

> (t)he Panel was concerned that the auditing profession has not kept pace with the rapidly changing business environment and found that "the profession needs to address vigorously the issue of fraudulent financial reporting, including fraud in the form of illegitimate earnings management" (p.6).

Furthermore, the paper notes that the auditor only provides reasonable assurance about the reliability of financial statements, meaning that the auditor is not liable for all frauds committed. For example, the auditor is not liable for frauds that have been ingeniously perpetrated. The paper further notes the Panel of Audit Effectiveness comments about the need for professional scepticism. The paper states that

> (t)he Panel also recommended the introduction of a "forensic type" phase where auditors would modify the neutral concept of professional scepticism and presume the possibility of dishonesty at various levels of management, including management override of internal control and falsification of documents (p.7).

As noted in last month's edition of *Current Affairs in Auditing*, the implementation of this recommendation would require many hours of training of field auditors.

It may be argued that the recommendations of the paper on the detection of fraud are merely recognising forces already in play. Evidence of this proposition is given in the paper where it acknowledges that in the USA *SAS 99 Consideration of Fraud in a Financial Statement Audit* was issued in October 2002. This standard gives auditors expanded guidance for detecting material fraud. The need for this standard is noted in the paper, when a quotation from the press release accompanying the issuance of the standard states that

> the standard is the cornerstone of a multifaceted effort by the AICPA to help investor confidence in US capital markets and to re-establish audit financial statements as a clear picture window into corporate America (p.7).

The paper states there is a distinction between financial statement fraud and other forms of fraud including defalcation of funds (p.7). The paper further states that consideration "be given to developing specific tests for other forms of fraud (including defalcation) and then reporting on the findings and the controls in place to prevent such funds" (p.7). The paper suggests that if the scope of the audit is not extended to detect frauds other than financial statement frauds, the public needs to be educated on this matter.

The distinction between financial statement fraud and defalcation of funds seems somewhat arbitrary. If a balance sheet figure for an asset is materially overstated as the asset or part of the asset is stolen and ceases to exist, then defalcation of funds can be classed as a financial statement fraud.

Evaluation of going concern

Similarly to fraud detection, evaluation of going concern is one of the two important areas of the audit expectation gap. The paper suggests that recent collapses such as HIH Insurance, One.Tel and Harris Scarfe have widened the gap (p.7). Auditors do have some responsibilities for going concern. Para .72 of AUS 708 Going Concern.

> The auditor should consider the likelihood that, during the relevant period, the entity will
>
> a) liquidate or otherwise wind up its operations; or
>
> b) be able to pay its debts as and when they fall due

Para .10 of AUS 708 states that companies should not use the going concern basis to prepare financial reports where reasonable foreseeable circumstances exist that it is not appropriate to prepare the financial statements on the above basis. The important point in the above is that reasonable foreseeable circumstances indicating the entity is not a going concern must exist at the time of the audit. Examples of these circumstances include negative cash flows, build up of unpaid creditors, unsaleable stocks and uncollectible debtors being on hand. Thus we can see clearly that the auditor is not responsible for going concern issues where reasonable foreseeable circumstances do not exist and these circumstances would be the basis of the gap relating to going concern. It is suggested that this interpretation of the circumstances constituting the gap would be narrower than those circumstances advocated by the profession.

The paper offers suggestions for dealing with the gap. These suggestions include auditors' commentary or reporting on

- performance indicators pertaining to financial health;
- non-financial indicators relating to a company's financial heath;

- the general financial health of a company; and
- the auditor making a positive assurance with respect to going concern (p.7).

A positive assurance means the auditor clearly states in the audit report that the company is a going concern. Being the least ambiguous statement about going concern, this is the best suggestion. However it would expose auditors to the greatest amount of litigation.

Conclusion

The issue of extending the scope of the audit and the inevitably of boom and bust economies (see second 'Current Affair' for July 2003) have important ramifications to the auditing profession. It appears the auditing profession will gain some form of reform on legal liability and thus the barriers to extending the scope of the audit will be lowered. The two most important areas relating to the audit expectation gap are fraud detection and going concern, and the auditing profession needs to extend their services in these areas to maintain relevance. Failure to do so could be the beginning of the extinction of the auditing profession.

If the auditor's services in relation to going concern are not extended, the existence of boom and bust economies could in the future enhance this process of extinction. If the auditor's services are extended in relation to going concern, boom and bust economies will certainly test the profession's ability to provide relevant services. Associated with collapsed companies is often fraud, especially financial statement fraud. The detection of this type of fraud would also be a key determinant to the auditing profession maintaining relevance.

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