An analysis on dealing with audit failure

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Abstract: Many highly publicized accounting scandals of the recent past seriously caused enormous losses to investors, hindered the healthy development of the capital market and damaged the credibility of the accounting profession. This paper gives a trial analysis on the reasons and precautionary measures of audit failure.

Key words: CPA; audit failure; countermeasures

1. Introduction

Recent years saw lots of financial frauds which have led to huge losses borne by innocent investors, creditors, employees, and others. Enron, WorldCom, etc. provide vivid examples of how internal control breakdowns and flawed and dishonest management and auditing can result in misstated financial statements that ultimately do great harm to national economy.

Audit failures meant that the accounting profession is confronted with a crisis of confidence and credibility. Criticism of the profession is widespread and harsh in the changing economic, social and regulatory climate in which the profession at present functions. Audit failures will endanger the existence of the profession and its development in the long run.

2. The causes of audit failure

2.1 External causes

In current economic environment, business risks result from intensified market competition may force the dishonest management of the entity to commit financial fraud. Such risks may arise from: (1) Industry developments and consequent potential business risks that entity does not have the personnel and expertise to deal with the changes in the industry; (2) New products and services, and consequent potential business risks that there is increased product liability; (3) Expansion of the business, and consequent potential business risks that the demand has not been accurately estimated; (4) Current and prospective financing requirements, and consequent potential business risks on loss of financing due to the entity’s inability to meet requirements, etc.

Moreover, poor corporate governance provides management opportunities to override controls and commit fraudulent financial report. Although China has experienced a process of corporate reforms for more than 10 years, but the external and internal mechanism of corporate governance is still far from efficient, thus a phenomenon exists, namely, “strong management and weak supervision”. Therefore, in order to manipulate the profit and mislead financial statements users’ judgment about the entity’s performance or profitability, fraud may involve sophisticated and carefully organized schemes designed to conceal it.

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2.2 Internal causes

Audit failure occurs when there is a serious distortion of the financial statements that is not reflected in the audit report, and the auditor has made a serious error in the conduct of the audit (Arens, 2002). Audit failure does not occur if the auditor has followed Generally Accepted Auditing Standards, regardless of the fairness and accuracy of the financial statements. A properly done audit does not guarantee that serious distortions of the financial statements have not occurred. However, a properly done audit does make serious distortions unlikely. Thus, audit failure cannot occur unless there is serious auditor error or misjudgment.

The nature of this auditor error has four systematic causes. First, the auditor can blunder by misapplying or misinterpreting GAAS. Such a blunder is unintentional and could be caused by fatigue or human error. Second, the auditor can commit fraud by knowingly issuing a more favorable audit report than is warranted. This may occur when the auditor accepts a bribe or bows to client pressure or threats. Third, the auditor can be unduly influenced by having a direct or indirect financial interest in the client. Fourth, the auditor can be unduly influenced because of having some personal relationship with the client beyond what is expected in a normal audit between independent parties.

3. The countermeasures of audit failure

It is urgent to take measures to cope with the severe situation of audit failures. Some are suggested as follows.

3.1 Maintain independence

The value of auditing depends heavily on the public’s perception of the independence of auditors. It is not surprising that independence is the first subject addressed in the rules of professional conduct. Independence is a crucial concept that sets auditors apart from the accountancy profession, as their core mission is to certify the public reports that describe companies’ financial status. By expressing an opinion, the independent auditor assumes a public duty. The function of “public watchdog” demands that the auditor subordinates responsibility towards the client in order to maintain complete fidelity to the public trust. The peril in the lack of independence is that the shareholders as a class who reads and relies upon the financial statements upon which the auditor has rendered an opinion to its detriment has a cause of action against the auditor. To serve such a class of persons an auditor needs to take an unbiased viewpoint when performing audit tests, evaluating the results therein, and issuing an audit report and opinion with respect to financial statements.

A topic related to independence is audit partner tenure. The policy of mandatory rotation of audit partners for a particular audit is suggested as a means of improving audit quality and therefore increasing the quality of general-purpose financial statements. The benefits normally espoused are that the independence of the engagement partner is maintained or that a new perspective on the audit may result in the identification of issues that have been overlooked on previous audits. Additionally, increased restrictions on auditor-client consulting or should reduce the likelihood of audit failure. How can a CPA firm be objective in evaluating the financial information of a client when that same firm helped to create the information system that they are judging? Moreover, the revenues generated from consulting may be sufficiently large to influence the auditor’s judgment regarding questionable accounting policies.

3.2 Exercise professional skepticism

An attitude of professional skepticism means the auditor makes an assessment, with a questioning mind, of
the validity of audit evidence obtained and is alert to audit evidence that contradicts or brings into question the reliability of documents and information obtained from management and those charged with governance.

Auditors are often liable when they are presented with information indicating a problem that they fail to recognize. Auditors need to strive to maintain a healthy level of skepticism, one that keeps them alert to potential misstatements, so that they can recognize misstatements when they exist. Auditors should plan and perform an audit with an attitude of professional skepticism recognizing that circumstances may exist that cause the financial statements to be materially misstated.

3.3 Moving audits from a traditional to a risk-based approach

Risk-based audit represents the developing trend of modern audit. It requires that the auditor must obtain a sufficient understanding of the entity and its environment, including its internal control, to identify, assess the risk of material misstatement of the financial statements whether due to error or fraud, and to design the nature, timing, and extent of further audit procedures. A risk-based audit allows CPAs to focus audit resources (dollars and people) on the highest risk areas. Resources are directed to areas where controls are weakest and audit procedures are tailored to the highest risk areas, thereby adjusting the audit scope. Thus, risk-based audit is more cost-effective.

The related procedures may include inquiries of management and others within the entity, analytical procedures, observation and inspection. The auditor’s understanding of the entity and its environment consists of an understanding of the following aspects: (1) Industry, regulatory, and other external factors; (2) Nature of the entity; (3) Objectives and strategies and the related business risks that may result in a material misstatement of the financial statements; (4) Measurement and review of the entity’s financial performance; (5) Internal control, which includes the selection and application of accounting policies.

After the understanding process mentioned above, auditors should identify and assess the risks of material misstatement at the financial statement level, and at the assertion level for classes of transactions, account balance, and disclosures. Moreover, in order to reduce audit risk to an acceptably low level, the auditor should determine overall responses to assessed risks at the financial statement level, and should design and perform further audit procedures to respond to assessed risks at the assertion level.

3.4 Enhance audit quality control

Quality control policies and procedures should be implemented at both the level of the audit firm and on individual audits. The accounting firm should establish a system of quality control designed to provide it with reasonable assurance that the accounting firm and its personnel comply with regulatory and legal requirements, the Code of Ethics for CPAs, standards on auditing, etc., and that reports issued by the accounting firm and engagement partners are appropriate in the circumstances.

The accounting firm’s system of quality control should include polices and procedures addressing each of the following elements: (1) Leadership responsibilities for quality control within the accounting firm; (2) Ethical requirements; (3) Acceptance and continuance of client relationships and specific engagements; (4) Human resources; (5) Engagement performance; (6) Engagement documentation; (7) Monitoring.

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3.5 Improve audit committees

Corporate governance is one of the key factors that determine the health of the internal control. As one of the important components of corporate governance, audit committee plays a very important role in reducing the risk
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of financial fraud.

It is necessary that auditors report to and are overseen by a company’s audit committee. This audit committee must approve all audit and non-audit services, must receive all new accounting and auditing information from the auditor, and must serve as the official line of communication between the auditor and the client company. Members of the audit committee are independent members of the board of directors of the company being audited, and at least one board member must be a “financial expert”.

3.6 Strengthen supervision over the CPA profession

The administrative supervision conducted by the competent departments over the CPA profession should start from guaranteeing the healthy development of the CPA profession, and aim at restoring the confidence of the public towards the CPA profession. The said departments should also, by imposing aggravated punishments on a few acts of violating laws or rules, protect most of the honest and law-abiding certified public accountants and accounting firms, rectify and regulate the accounting order, as well as promote and guarantee the healthy development of the CPA profession.

The supervision and inspection institutions of the competent departments should be responsible for the administrative supervision over the CPA profession, monitor the practicing quality of the CPA profession, lawfully inquire into, investigate, inspect, deal with and punish the acts of violating laws or rules, and do a good job of coordination and guidance.

4. Conclusion

The circumstances in which companies operate have been more challenging and more than ever, fighting against financial frauds is of great importance to CPA profession. This paper analyses the causes of audit failure from both the external and internal aspects which mainly are poor corporate governance and lack of independence of the CPAs. This paper gives suggestions on how to cope with audit failure. It is critical for CPAs to maintain independence, professional skepticism. The CPA profession should perform the risk-based audit and improve audit procedures. Further more, it is quite necessary to improve audit quality control, audit committee and strengthen supervision over the CPA profession.

References:


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