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EXPERT ANALYSIS

# Advancing the Art of Auditing by Following The Lead of Federal Authorities

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The auditing profession, when criticized for failing to detect financial reporting frauds, reflexively points to the fact that a high proportion[1] of audits are seemingly free from audit inadequacies. This claim is largely based on the fact that only a minute fraction of audited financial statements are later found to have been materially false or fraudulent. It is not based on any scientific sampling of apparently well-done audits, involving a thorough "soup to nuts" re-performance of those engagements for the purpose of uncovering defects.

As with the proverbial tree that falls in a forest with no one around to hear it, there may be many poorly conducted audits that are never observed either. That is because the audited financial statements are not subject to fraudulent manipulations, or because whatever irregularities exist are never brought to light.[2]

It is well cited that American businesses lose as much as 5 percent of revenues annually to various forms of fraud. Couple that with the equally disturbing fact that very few discovered frauds are uncovered by outside auditors, and it seems more plausible that many audits are, at worst, materially deficient or, at best, of only mediocre quality.[3]

Notwithstanding the venerable requirement that audits be planned and conducted to control at a low level the risk of the financial statements containing undetected material misstatements due to fraud or error, improvements can and must be made. If the profession fails to effectively address this, traditional audits by independent accountants may be superseded by new players, using alternative technology and processes in ways, perhaps, not yet contemplated.

Inspections of the work performed by auditors of publicly held companies, or "issuers," conducted by the Public Company Accounting Oversight Board have found a high proportion of poorly conducted audits, with 28 percent to 49 percent of sampled engagements revealing various flaws.[4] These include:

- Lack of sufficient, competent evidence to support the opinions rendered.
- Failure to maintain a proper attitude of professional skepticism.
- Insufficient consideration of the risk of fraud.
- Inadequate disclosures of related party transactions.
- Insufficient or inappropriate use of analytical procedures.

- Failure to properly conduct the required audit of the clients' system of internal controls over their financial reporting processes.

Although not subject to such PCAOB inspections, audits of non-issuers (*i.e.*, privately held businesses, governmental units and not-for-profit organizations) presumably would fare no better, overall, in terms of the quality of work performed. With even a deficiency rate of 28 percent being intolerable, there is obviously room for improvement in the conduct of audits.

Though criticisms have been leveled at the standard setters (the PCAOB for public company audits; the American Institute of Certified Public Accountants' Auditing Standards Board for others), the problem is not really inadequacies in the standards, but rather weakness in performance. The tools that can be useful for auditors (*e.g.*, confirming receivables, observing inventories, comparing analytically derived expectations with client representations) are mostly uncomplicated and well understood.

The concern is that these tools are either applied to a much too limited population of items or carelessly misapplied. Alternatively, they produce findings that are misinterpreted by the auditors, ignored or rationalized away, often at the behest of clients offering explanations that are not credible.

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For example, auditors too often rely on client instructions regarding sending of receivables confirmations. Sometimes auditors even allow client personnel to "mail"— or, increasingly, "email"— these to customers, thus relinquishing control over the process and permitting misdirection in furtherance of fraud.

Similarly, the practice of informing clients of the locations where inventory taking is to be observed all but invites opportunistic manipulations to conceal shortages (as the infamous Phar-Mor dispute demonstrated[5]).

Small sample sizes, the use of invalid "block sampling," the blanket acceptance of excuses for suspicious findings without independent corroboration and obliviousness to what should be seen as "red flags" are all performance failures that do not implicate deficient standards.

Nevertheless, auditing methodology might be ripe for some fresh thinking, particularly regarding assessing and responding to the risk of financial reporting fraud. Help may be on the way from the PCAOB and the Securities and Exchange Commission, which have each begun efforts to improve the timely detection of "red flags" indicative of possible irregularities warranting expanded audit attention.

Created in mid-2013, the SEC's Financial Reporting and Audit Task Force will reportedly attempt to bring a new perspective to the detection of financial and accounting fraud, and will most likely use data mining and a range of analytical procedures. The to-be-developed Accounting Quality Model[6] will provide a gauge (perhaps comprised of as many as 20 separate indicators) of the extent to which a given registrant's financial submissions appear anomalous, and thus worthy of closer review.

Analytical procedures have long been prescribed for planning and final review stages of audit testing, and recommended for optional use in substantive testing, but in many observers' opinions, these procedures have not been well-utilized by the auditing profession. To the extent that the SEC's efforts can point to more effective use of these tactics — and be shared freely with the profession — these analytical procedures may be the "next big thing" in auditing methodology and fraud deterrence and detection.

The SEC will have greater volumes of data to compare than will the typical audit team, and thus, a potentially more useful framework for flagging outliers for closer review. Too often, though, auditors have eschewed full use of the data readily at hand.

In particular, auditors have ignored or seriously underemployed disaggregated financial statement data of the auditee (*e.g.*, sales by product line, by location of production or storage, or by portion of the reporting period when ostensibly occurring). These have great potential to flag

anomalies, such as end-of-period window dressing transactions, fraudulent channel-stuffing, intra-company transfers, and so forth.

Even if the SEC's analytical advances use cross-company comparisons, the tools themselves may be directly employable for within-auditee company utilization, and furthermore, they may stimulate the development of creative extensions by auditors themselves. Auditors might also be inspired by a corollary SEC effort focused on "aberrational performance indicators," which would require auditor understanding of client industry performance factors. This is presumably already demanded by Generally Accepted Auditing Standards as a threshold condition for being qualified to conduct an audit.

The PCAOB, which is assisting in the SEC project, also has its own project underway to develop audit quality indicators. This is consistent with the board's role in overseeing auditors, whereas the SEC's primary focus is on overseeing financial reporting by registrants.

According to a recent report,[7] the PCAOB is exploring such matters as the following:

- the effect of attitudes and behaviors, including cognitive biases, on the aptitude for fraud detection;
- approaches and methods, including use of technology, employed by other disciplines to detect fraud that might be applied by financial statement auditors; and
- the knowledge and skills, including forensic training, needed for effective fraud detection.

As with the SEC's efforts, it is to be ardently hoped that any advances made will be shared with the auditing firms. In this way, improved auditing techniques can be implemented to prevent the creation and dissemination of fraudulent financial reports, rather than only detecting these after investors have been put at risk.

Auditors should welcome — and, to the maximum extent possible, participate in — these developments, which may serve to enhance, or even to salvage, the profession's role in the world of commerce.

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## NOTES

[1] The proportion is well over 99 percent, based on the fact that there are over 12,000 public companies that file with the SEC and are audited each year, plus a multiple of that number of privately held companies. Many of these are also audited; yet, there are only a handful of frauds reported each year.

[2] Peer reviews and other practice monitoring arrangements do undertake such reviews of a small sample of firm engagements during the period under review. Recent practice reviews conducted by the PCAOB have reported a much higher fraction of engagements affected by audit failures, although the use of this descriptive term has been disputed. The large CPA firms' audit failure rates are discussed by various commentators, for example, at http://goingconcern.com/post/mcgladreys-pcaob-inspection-report-least-embarrassing-thing-about-mcgladrey.

[3] *See, e.g.,* Ass'n of Certified Fraud Examiners, Report to the Nations on Occupational Fraud and Abuse (2014), *available at* http://www.acfe.com/rttn/docs/2014-report-to-nations.pdf. It is projected that the estimated 5 percent of losses to occupational fraud and abuse, applied to Gross World Product, amounts to some $3.7 trillion. The study finds that only 3 percent of frauds were uncovered primarily because of the efforts of independent auditors.

[4] Tammy Whitehouse, *PCAOB Report on EY Hammers Hard on Internal Control,* Compliance Week, Aug. 29, 2014), *available at* http://www.complianceweek.com/blogs/accounting-auditing-update/pcaob-report-on-ey-hammers-hard-on-internal-control#.VK7uVihovjl. Other sources, addressing other years' inspections, are fairly consistent in finding a surprisingly large fraction of audits exhibiting various failures.

[5] For a description of that fraud, which relied upon ostensibly transferring inventories to those locations the auditors had indicated would not be among those actually tested, *see, e.g., Frontline, How to Steal $500 Million* (PBS television broadcast Nov. 8, 1994) (transcript *available at* http://www.pbs.org/wgbh/pages/frontline/programs/transcripts/1304.html). *See also A Scandal Waiting to Happen,* Businessweek, Aug. 23 1992, *available at* http://www.businessweek.com/stories/1992-08-23/a-scandal-waiting-to-happen.

[6] For a description of this project, *see, e.g.,* Craig M. Lewis, Chief Economist and Director, Division of Risk, Strategy, and Financial Innovation, U.S. Sec. & Exch. Comm'n, Speech at the Financial Executives International Committee on Finance and Information Technology: Risk Modeling at the SEC: The Accounting Quality Model (Dec. 13, 2012) (transcript available at http://www.sec.gov/News/Speech/Detail/Speech/1365171491988#.VK7xnyhovjI).

[7] *See* Pub. Co. Accounting Oversight Bd., The Auditor's Approach to Detecting Financial Statement Fraud (Nov. 20-21, 2014).

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