Expect More Major Audit Failures

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Successive sudden and major corporate collapses have caused serious economic and social damage in the UK and elsewhere. While auditors are not responsible for corporate collapses, they are increasingly being blamed for failing to do their job by not alerting stakeholders to matters that may indicate an impending corporate failure. All too often, a collapsed company has provided misleading information to stakeholders that its auditors failed to detect and report.

The UK government has recently started various initiatives, including changes to regulations, to help build trust and credibility in that country's audit, corporate reporting and corporate governance system.[1] Large auditing firms indicate that they are continuing to improve their quality control processes and use more sophisticated and effective automated audited procedures, including data analytics. Quality control standards for firms have also recently changed. While no doubt helpful, will these efforts prevent the most egregious headline grabbing failures? Likely not. These failures, while devastating, are rare and hard to prevent – behavioural and audit firm cultural factors will always cause a few auditors to ignore rules, codes and quality controls and behave unethically.

Major Audit Failures Are Rare but Devastating

Major audit failures are rare. The top 20 stock exchanges worldwide have a total of over 30,000 registrants (ranging from a few very large companies to many smaller ones) that must be audited.[2] Out of all these audits, there are less than a handful of major audit failures that make headlines each year. However, corporate stakeholders and regulators quite rightly view even a few major audit failures as too many because of their devastating large scale financial and social effects, including a loss of trust in capital markets. Arguably, these failures are similar to "black swan events" – rare, unpredictable events that have severe negative consequences. Regulatory and audit firm initiatives will not eliminate major audit failure but may help turn them into "grey swan events" – still catastrophic but more predictable and less likely to occur. The reason is that various initiatives cannot effectively address all significant factors that underlie audit failures.

Factors Underlying Major Audit Failures

Audit failures often go hand-in-hand with corporate failures. In their meta-analysis, Kish-Gephart, Harrison and Trevino suggest that corporate failures result from factors relating to

bad cases, bad apples and bad barrels.[3] Bazerman, Lowenstein and Moore propose a number of factors that lead to unethical behaviour by auditors.[4] Table 1 shows some of both sets of factors.

Table 1 – Examples of Factors Contributing to Unethical Behaviour by Auditors

BAD CASES (*Characteristics of specific circumstances encountered that may provoke unethical choices*) *	
Ambiguity	Significant judgments required by accounting and auditing sometimes allow for considerable interpretation and leeway.
Approval	Self-serving bias of auditors and management are more likely to align since auditors do not make original accounting judgments (they either approve or reject those of management).
Attachment	Auditors are under significant pressure to retain important clients to avoid loss of audit and consulting fee revenue and to help advance their public accounting careers.
Discounting (temporal immediacy*)	Potential negative consequences for auditors of standing up to management pressure are viewed as clear and immediate (e.g., loss of the client, loss of employment). Potential positive consequences are viewed as distant and uncertain (e.g., avoiding a lawsuit against the firm and maintaining its reputation).
Escalation	Auditors may decide to conceal a matter that is now material when it results from an accumulation of matters previously ignored because they were mistakenly interpreted as being immaterial.
Familiarity (proximity*)	Auditors are more likely to decide to risk harming faceless corporate stakeholders than harming their relationship with client management with whom they are familiar.
Minimizing the magnitude of consequences	Underestimating or ignoring the potential total amount of harm that could result from unethical choices. *
BAD BARRELS (*Organizational environments that have negative characteristics*) *	
Poor ethical climates and cultures	Environments that reduce or negate the effectiveness of codes of conduct and other policies, procedures and controls. *
BAD APPLES (*Psychological characteristics of some members of management or the audit engagement team*) *	
External locus of control	*Tendency to offload blame to someone or something else.* *
Low level of job satisfaction *	
Low level of moral development *	
Machiavellianism	An aptitude for deceiving people for personal gain. *
Moral relativism	An attitude that an unethical act is acceptable because of a perception that everyone else does it too. *

Notes:
1. *Source: Kish-Gephart, Harrison and Trevino (see reference in endnote 3). Other factors noted were identified by Bazerman, Lowenstein and Moore (see reference in endnote 4).
2. Descriptions of factors have been significantly abbreviated and simplified from the original material.

In rare circumstances, a bad case may be concurrent with an audit firm having a bad barrel culture and the audit engagement team being led by a bad apple. The accounting profession is

not rife with crooks, however, and audit failures sometimes result because factors make auditors vulnerable to unconscious bias.[5] A major audit failure, when the engagement partner is not necessarily a bad apple, might look somewhat like this:

- The company being audited is far from meeting marketplace expectations regarding its financial or other performance targets. Senior management (some of whom are bad apples) decide to fraudulently manipulate financial results to present a picture that will help ensure that the prices of the company's stock do not decline. In particular, they take advantage of areas of accounting that involve estimation uncertainty, complexity and subjectivity (i.e., areas of ambiguity). Examples include when and how much revenue to recognize on long-term contracts, determining cost allocations, making estimates such as those related to credit losses, inventory obsolescence and determining whether goodwill or intangible assets have been impaired. Management uses a combination of biased assumptions, methodologies and selection of data in determining amounts to be recorded and presented in its financial statements. As a result, the company's financial statements are not prepared in accordance with generally accepted accounting principles and are, therefore, misleading.
- Audit and other fees earned from this client are very large, not only for the particular office undertaking the engagement, but for the firm as a whole. Therefore, the engagement partner and other firm personnel are under significant pressure to not risk losing this client. Resisting how company management proposes to account for various transactions would greatly increase this risk. As directed by the engagement partner, the audit team is not very skeptical about some key aspects of management's accounting. Management's rationalizations are accepted on the basis that there are many judgments involved. The team relies heavily on management's representations without obtaining sufficient appropriate evidence from other more persuasive sources.
- Previous audits led by the same engagement partner identified similar dubious approaches to accounting by management but they were judged to be immaterial. For the current year, the immateriality argument is no longer valid. Management points out, however, that the auditor has accepted the proposed accounting treatments in the past, so it is not reasonable to change course now.
- Under significant pressure from company management, and a strong desire to retain the client, the engagement partner does not raise any concerns with the audit committee, agrees to issue a clean audit opinion on the financial statements and not mention in the auditor's report, as key audit matters, significant debates held with management regarding aspects of their accounting. The engagement partner convinces the engagement quality reviewer (who also does not want to risk losing the client), to concur with her decisions.
- The company's efforts to pretend it is successful fail and it collapses. Subsequent investigations determine that, in the view of regulators, the audit failed. Lawsuits against the company and auditors ensue.

No firm wants audit failures and their codes of conduct prohibit bowing to undue client pressure. But, because of factors like those in Table 1, some of their assurance personnel may be highly motivated to go along with what management wants, even when they know, or should know, that this decision would contravene generally accepted accounting principles, generally accepted auditing standards, rules of professional conduct and their firm's code of

conduct. A key question, then, is whether these factors can be mitigated so that the number of major audit failures, if not entirely eliminated, can be significantly reduced.

Reducing the Attachment Factor

The attachment factor often means putting an accounting firm's business interests (i.e., making sure to keep audit clients who pay high fees) ahead of professional interests requiring independence from the client. The view has often been expressed that the best way to eliminate this attachment factor would be to replace the current "client-pays-the-auditor" model. The Project on Government Oversight (POGO) provides reminders of other models that have been suggested, including risks that likely would make them unworkable (see Table 2).[6]

It seems highly improbable that legislators, regulators and auditors would cooperate to undertake a high-cost, very complex initiative to change the current model when its outcome might not improve auditor objectivity. To paraphrase Winston Churchill's comment on democracy, the current model is the worst, except for all the others.

Table 2 – Possible Alternatives to "Client-Pays-Auditor" Model

Options	Risks
1. Government regulator performs the audits. Funding provided by taxation.	• Political interference (including withholding adequate funding) as result of lobbying. • Many qualified auditors may not want to become public servants.
2. Government regulator assigns and pays auditors. Funding provided by audited companies.	• Lobbying risk (see above). • Complexity in determining appropriate audit fees.
3. Stock exchanges assign and pay auditors. Funding provided by audited companies.	• To attract and keep listed companies, exchanges may have a strong incentive to make audits less costly or burdensome. • Complexity in determining appropriate audit fees.
4. Insurance companies provide policies to pay investors if, post-audit, audited financial statements are found to be false. The insurance company hires and pays auditors, with fees recovered from the insured companies.	• Highly complex issues around wording of terms of insurance policies and assignment of auditors. • Insurance company and auditors could have a strong incentive to hide problems discovered after completion of an audit that would result in large claims having to be paid.
5. Companies periodically engage third party "red teams" paid on a contingency basis, depending on the size of any required restatements they identify. These engagements would be in addition to traditional annual audits.	• No incentive for companies to engage "red teams." • Business model would not work for "red teams." If they found a significant problem resulting in a company's collapse, they likely would not get paid.

Changing the Culture of Audit Firms

Negative views on the ethical culture of audit firms can be quite extreme. For example, in their 2018 submission to the UK CMA's *Statutory Audit Market Study*, a group of academics and audit experts asserted that the culture and ethics of auditing have failed miserably at too high a cost to society. In their view, the Big 4 firms have become entirely profit-oriented commercial entities, helping clients to secure public contracts and assets while avoiding taxes on an industrial scale, producing a generation or more of professional accountants who have gone on to run big corporations with this culture and values, so spreading the virus.[7] Even those with more moderate views, however, were likely taken aback when regulators fined some large firms millions of dollars because personnel, including auditing professionals, cheated on training exams (including ethics-focused training).[8] [9] [10]

Maintaining independence and objectivity are fundamental to an effective culture for audit firms. The UK CMA Market study revealed some troubling information about criteria used by companies to select auditors. In a sample of FTSE company audit committees, 23 out of 24 explicitly used criteria such as "fit," "cultural fit" and/or "chemistry." Only nine explicitly included "exercising skepticism" and/or "challenging management" as criteria.[11] Descriptions of "cultural fit" included having closer affinity, being relationship focused, showing a strong desire to work with the company and not being too difficult in discussing accounting treatments. Only rarely did good cultural fit refer to being able to effectively question and challenge management.[12] Some auditing firms took the position that use of terms like "chemistry" and "cultural fit" simply reflect the role of important service quality factors, which are key parameters of competition in an industry like auditing.[13]

The CMA study concluded that the weight attributed to factors like "cultural fit" and "chemistry" calls into question whether the current tendering approach rewards auditors for being close to management, rather than providing independent challenge.[14] Also, the CMA concluded that, despite input received from firms to its study, audit appears to have a relatively weak voice within these firms in driving culture and values.[15]

But, while firms are working to improve their cultures, major accounting failures continue to occur.

The concern that auditors may have too weak a voice in large firms is leading regulators in some jurisdictions to urge firms to split into two separate entities. One would provide assurance services (e.g., audits, reviews), the other advisory and consulting services. The SEC believes that auditor independence is grounded in an understanding of accounting as a profession rather than an industry, which is critical to serving the public interest.[16] Auditors are expected to be objective and challenge clients when appropriate. Consulting and advisory services, on the other hand, are an industry entirely focused on working with clients to improve many aspects of their business. Therefore, the ethical cultures required for each of the respective types of services are, in many respects, incompatible.

EY has indicated that its partners will be voting on whether to split that firm. Other firms have not said whether they will follow EY's lead. Even if they do, effects could be temporary. After the collapse of Enron and implementation of the Sarbanes Oxley Act in

the US over 20 years ago, some firms split out their consulting arms but, like starfish, they regrew them. That is not surprising since the audit process often provides insights into where a company could improve aspects of its operations. Also, a service such as recommending how to address weaknesses in internal control identified during the audit is an important by-product of the audit, clearly in the public interest and, therefore, allowed by rules of professional conduct. Other advisory services are also allowed if the firm has implemented appropriate safeguards to ensure its independence. Therefore, auditors are likely to continue to be tempted to expand services beyond auditing. But questions arise as to how effective safeguards can really be. For example, it would likely be quite difficult to design and implement effective safeguards when a firm is providing business acquisition advisory services to a non-audit client and one or more of current or potential acquisition targets are audit clients. Therefore, splitting auditing from consulting is, at least temporarily, likely to help implement an audit-focused culture in a new separate assurance services entity.

Changing audit firm culture is not easy. A recent study (a synthesis of previous research) indicates that the culture of an audit firm is most oriented toward quality if its leadership emphasizes professionalism over commercialism, promotes ethical judgments and facilitates learning through systems, integration of specialists and interpersonal interactions among auditors. This involves embedding mechanisms (organization conditions) such as rewards, training, resources, organizational design, systems and procedures. Those mechanisms influence perceptions of audit firm culture, auditor behaviour, work attitudes and audit quality.[17] But, while firms are working to improve their cultures, major accounting failures continue to occur.[18]

Recent changes in standards for quality management of firms providing assurance services mirror the above, and will help firms address complexities related to cultural change. These new standards specifically recognize, for example, that audit quality management is not a separate function of the firm – it is the integration of a culture that demonstrates a commitment to quality with the firm's strategy, operational activities and business processes. Also, the standards contain specific requirements and supporting guidance to establish quality objectives, systems and processes that recognize the importance of maintaining professional ethics, values and attitudes. [19]

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Nevertheless, cases will no doubt still arise where the integrity of audit personnel will be severely tested by client pressure, and pressure from within the firm, to put the firm’s and personal financial interests ahead of professional interests. Realistically, personnel may focus on trying to avoid putting their household finances in jeopardy. A strong desire to continue putting food on the table will sometimes win out.

Brace for More Scandals and Audit Failures

The Economist suggests that if, as expected, the global economy sours, we should brace for a wave of scandals as a result of corporate fraud – "The big scandals play out like tragic dramas: when the plot twist arrives, it seems both surprising and inevitable."[20] Major audit failures are often linked to corporate collapses, so more are likely on the way. Most recently (at time of writing), the crypto world was rocked by the collapse of FTX, with a complaint alleging audit failure.[21]

Going forward, some firms may still put much of their effort into improving audit quality by continuing to design and implement more effective and efficient automated audit procedures. But as famous physicist and author Arthur C. Clarke said, "As our own species is in the process of proving, one cannot have superior science and inferior morals. The combination is unstable and self-destroying."[22] As well as continuing to making significant technical advances, auditing firms must, at the same time, firmly commit to putting ethical conduct ahead of business considerations. Otherwise, the profession may as well push a self-destruct button on its credibility and the esteem in which it would like to be held.

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