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Audit Failures and Risk Alerts in an Age of Global Uncertainty

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As 2011 draws to a close the world is facing a great deal of uncertainty about the World Economic Order. Are we to be hit by another global recession? Or is the recession of 2008-09 continuing and were all the talks of recovery only wishful thinking? Will the Eurozone break up? Are the growth rates really slowing down in India and China or is this a temporary aberration? Unfortunately as 2012 approaches we do not have answers to most of these questions. While we grope amidst all these uncertainties one fact stares us in the face ——— Corporate failures, bank failures and systemic failures continue unabated and the numbers and magnitude are staggering.

While the world is coming to grips with the fact that mature economies like Greece and other European countries have just been pulled back from the brink of sovereign debt default, the failures among banks and other financial sector entities continue unabated. In the U.S. alone, 140 banks failed in 2009, 157 failed in 2010 and in 2011 upto 18th November 90 banks failed. Again in the United States mortgage related business failures were 230 in 2009 and 201 in 2010 and in 2011 in the U.S. upto November 13 Insurance Companies failed.

In the light of these statistics and various studies indicating that many other entities are under threat one question is increasingly engaging public attention. The question is – what were the auditors doing while these businesses fell like nine pins? There is very recent news that in Germany the nationalized mortgage bank, Hypo Real Estate has recently discovered an accounting error of € 55 billion after the audit (by PWC) was over and the accounts containing such error were published. There is news that the Japanese camera maker Olympus has been hiding for two decades large losses relating to security investments. And recently newspapers carried news that Olympus has restated its past accounts recognizing these losses. There is news that MF Global, the recently bankrupt broker-dealer and Futures Commission Member was given a clean chit by its auditors (PWC) about its controls as recently as in May 2011.

There is further news about more European financial sector entities, such as Austria's Erste Bank which was wrongly treating credit default swap contracts as financial guarantees and Dexia the French- Belgian lender which had to take a Govt. bailout but had been getting clean bills of health from its auditor.

As such news pours in and as people look back into the past to recollect major accounting scandals such as Satyam in India, Tyco International, Qwest Communications, Worldcom, Waste Management, etc., it is very obvious that the accounting and auditing profession is increasingly

suffering from a credibility gap. Such credibility gap is best described in the language of The Economist which in an article published in April, 2003 described current models of financial reporting as producing little more than a “brittle illusion of accounting exactitude”. Of course the auditing profession prefers to use a more polite expression and prefers to call this the expectation gap which is defined as the perceived difference between what the auditors are expected to accomplish and what the auditor himself believes that he must accomplish.

Whatever may be the gap in auditors’ performance there is no doubt that litigation against the auditors is increasing and many regulators are coming out with adverse findings against auditors. To give a few examples, in the first major action against the auditors in connection with the financial meltdown of 2008-09 the U.S. prosecutors are about to file civil fraud charges against the auditors (E&Y) of failed Lehman Bros., saying that the audit firm stood by while the investment bank misled investors about its financial health. In this case the Bankruptcy Examiner’s report has already found that a “colourable claim of professional malpractices exists against the auditors”.

There is also recent news that Commodity Futures Trading Commission in the U.S. have subpoenaed the auditors (PWC) in connection with the failure of MF Global.

Across the Atlantic in the United Kingdom the Accounting and Actuarial Discipline Board has been carrying out investigations in connection with audits done (by KPMG) of British Aerospace / BAE Systems. The attempt by the auditor of the failed Anglo Irish Bank (E&Y) to halt the probe into its audit of the failed bank has been rejected by the High Court and the special investigator appointed by the Institute of Chartered Accountants in Iceland to look into the collapse of the Anglo Irish Bank has also issued a statement that the auditors (E&Y) need to answer various points which are under inquiry. In Iceland the group of investigators commissioned by the Icelandic prosecutor has found an audit failure (by PWC) in the audit of two Icelandic Banks. There is also news coming in that the auditors of the numerous funds which invested money with Bernie Madoff are being questioned as to why they did not raise the red flag in respect of these investments.

Also in the U.S. litigation has been brought against the auditors (PWC) by the investors of the bailed out insurers AIG and similarly the bankruptcy trustee of the failed futures broker Refco Inc. is seeking damages from the auditors of Refco Inc. (also PWC).

What conclusion do we draw from this spate of increasing litigation? The conclusion is as the world goes through greater economic volatility, as sovereign nations slip into debt traps, as currencies fluctuate sharply, the risks and uncertainties increase. Such risks cause more business failures and going by the current trends, when businesses will fail people will turn

the heat on the auditors and the auditing profession will be under increasing pressure to defend itself against charges of culpability.

How then should the auditing profession prepare and change? How should the auditor behave in an environment of increasing risk and uncertainty?

The answer to this situation is for the auditing profession to understand the changes that are taking place in the environment, in the methods of financial reporting, in the practices of risk assessment and finding methods of addressing uncertainties.

While I shall come back to the issues of audit risks and Risk Alerts, it will be useful to spend a little time discussing the changes in financial reporting and audit practice. An excellent report produced by the Chartered Accountants of England and Wales in the year 2009 has identified major changes in the practices of financial reporting. These changes are: –

- Changes in financial reporting standards and the increasing importance and the rigor of standards. Let me explain this. Preparation of a/cs is today driven by Financial Reporting standards and Interpretations. There are quite a few of them. Going by the latest tally, there are thirty eight IASs and IFRSs and twenty five IFRICs and SICs (which are interpretations) and quite a few more to

be made mandatory in the near future or are in draft stage and many of these are under continuous revision and overhaul. Many of these Standards and Interpretations have changed over the years and are not like the old principle based standards which were easy to understand and follow but include detailed rules and methodologies. If you pick up just one Standard IAS 39 on Financial Instruments Recognition and Measurement you find that since 2003, IASB has issued nine amendments (including amendments on complicated issues such as Fair Value Hedge Accounting for a portfolio hedge of interest rate risk, embedded derivatives, etc.). Not only have there been nine amendments, but IFRS39 has also been amended by thirteen other IFRICs and IFRSs and there are now seven IFRICs and SICs which refer to this IFRS 39. The situation is similar with many other IFRSs and as businesses get more complex this trend will accelerate. Standards and IFRICs are being issued to tackle acknowledged problem areas including off Balance Sheet finance, Capital investments, regulatory assets, extinguishing financial liabilities with equity investments, etc. Financial reporting is therefore no longer based on overall principles but has to comply with detailed methodologies and disclosure requirements and the consequences of non-adherence are serious.

- The second change in financial reporting identified by the report of the Institute of Chartered Accountants of England and Wales is more fundamental. In the past financial reporting used to deal with mostly historical data such as costs, revenues, losses, etc. Dealing with the

past was safe as data was reliable and easily quantifiable. But a feeling has now developed that historical data is not very relevant. Financial reporting must supply information to the owners (who provide the capital) that will help them assess prospects of future cash flows. Therefore it is not enough to charge to Profit & Loss A/c, the cost of leave encashed by employees. Now the accounting standard requires that the future encashment of leave by employees must be assessed and discounted to present value and then charged to Profit & Loss A/c. It is not enough that we charge depreciation on an asset based on its estimated useful working life. Now we must assess whether a group of assets that generate cash will generate sufficient cash in the future to justify their being carried at a certain value and if the answer is No, we must further provide for impairment of assets. In other words for financial reporting to be more relevant, it is looking more towards future probabilities and making assumptions. The earlier emphasis on historical data increased reliability of financial reporting and reduced the risk both for auditors and preparers of financial statements. Today the increasing importance of future probabilities have increased the uncertainties in financial reporting and increased risks. This means that financial statements will increasingly contain information that is not capable of being audited in the same way as other traditional elements of financial statements. That is why financial reporting today requires detailed disclosures of assumptions based on which the financial statements have been prepared and the auditor therefore has to examine the use of these assumptions, their

reasonableness and can no longer be satisfied with verification of historical data. The job description and the job content of the auditor are undergoing serious change.

- The third major change identified by this report is the increasing use of fair values. IFRS 13 Fair Value measurement (to be effective from 1..1.2013) says that the global financial crisis has emphasized the importance of fair value measurement but fair values have been around for quite some time and are used in a number of standards including Financial Instruments, construction contracts, employee benefits, revenue, etc. Measurement of fair value is again a task that bring in uncertainties, especially, considering the volatility of today's markets and economies. Here again the auditor has to reorient his tools to audit financial reporting that contain fair value measurements.

It is clear therefore that auditors have to reassess their approach to audit and risk evaluation in the light of these changes in financial reporting.

Auditing standards have also developed ways to tackle uncertainty and potential variability of economic outcomes. Firstly, there is a much greater focus on audit risk, so that more work is done during audit planning to assess those areas that require most attention. The extent to which any particular element of the financial statements involves significant judgement because of its uncertainty or potential variability will be a factor in the audit risk analysis.

The issue of assessing risks in auditing has been the subject matter of various international pronouncements. The International Standard on Auditing 315 deals in detail with identifying and assessing the risks of material misstatement through understanding the entity and its environment. It lays down detailed procedures for risk assessment procedures and related activities. It outlines steps for the required understanding of the entity and its environment including the entity's internal control and it also spells out the steps in assessing the risk of material misstatement. ISA 330 deals with the auditors' procedures in response to assessed risks and ISA 400 deals with risk assessments and internal controls.

The issue of Risk Alerts arises from the concept of audit risks. The Risk Alerts utilize the term Engagement Risk in describing various risks auditors consider in performing an engagement. Engagement risk encompasses risks borne by both the auditor and the client entity. Engagement risk represents the overall risk associated with an audit engagement.

An entity's business risk is the risk associated with the entity's survival and profitability. In contrast to entity's business risk, audit risk is the risk that the auditor may unknowingly fail to appropriately modify the opinion on financial statements that are materially misstated. The concept of auditor's business risk is in addition to audit risk. This risk arises from the fact that the auditor is exposed to loss or injury to his professional practice

from litigation, adverse publicity, or other events arising in connection with financial statements that he has examined and reported on.

The concept of Audit Risk Alerts arises from the importance of audit risks in carrying out an audit. Audit Risk Alerts provide auditors of financial statements with an overview of recent economic, industry, technical, regulatory, and professional developments that may affect the audits and other engagements they perform. Updated annually, alerts also help identify the significant business risks that may result in the material misstatement of a client's financial statements. Audit Risk Alerts also can be used by an entity's internal management to address areas of audit concern.

Audit Risk Alerts could be issued on a national level or could be issued for specific industries such as the building industry, the banking industry, insurance industry, etc. In the United States such Risk Alerts have been issued for employee benefit plans industry, financial institutions industry, health care industry, investment companies industry, life and health insurance industry, not for profit entities industry, property and liability insurance industry, real estate and construction industry, service organisations, etc. Normally Audit Risk Alerts cover areas in respect of which risk assessments have to be done as these areas could be sources of major risks of financial misstatement. For example: the AICPA has issued Audit Risk Alert for the year 2011-12 covering the following areas:

- Business combinations
- Troubled Debt Restructuring
- Disclosures about credit quality and Allowances for Loan Losses
- Embedded credit derivatives
- Fair Value Measurements
- Goodwill impairment test
- Milestone method of revenue recognition
- Modification of loans within a pool
- Multiple deliverable revenue arrangements
- Share based payment awards
- Software elements

It is obvious that all the above represent complex business transactions or use of financial instruments or use of estimates which could lead to major uncertainty. These Risk Alerts issued in the year 2011-12 represent concerns about possible areas of financial misstatement in a post global meltdown era. However, depending on the time and the country and the context these Risk Alerts would change. For example, in the year 2000 the U.S. Securities and Exchange Commission issued Audit Risk Alert to the AICPA which had as major issues: –

- Amortisation of major advertising costs
- Appropriate classification of accounts within the income statement and the balance sheet.

- Disclosures of the impact of recently issued accounting standards
- Treatment of intangible assets arising out of business combinations
- Employee pension and other postretirement plan disclosures
- Segment disclosures
- Allowance for loan losses
- Revenue recognition
- Income Tax shelters
- Stock compensation
- Accounting for convertible securities with beneficial conversion features
- Documentation and disclosure related to derivative instruments and hedging activities
- Financial instruments and derivative contract terms
- Equity method of accounting for investments in common stock
- Changes in accounting policy
- Foreign currency transactions, etc.

It is seen that the focus on Audit Risk Alert has changed significantly from 2000 to 2012 and items such as troubled debt restructuring, fair value measurements are new features in the Risk Alert.

The use of Risk Alert as an innovative audit tool to assess audit risks is now fairly widespread. In India regulators for banking and insurance

industries issue prudential norms which draw attention to desired accounting treatment in specific areas such as restructuring of troubled loans, derivative losses, etc. Quite often auditors with clients operating across borders issue Risk Alerts to their counterparts in other countries for the specific client. These Risk Alerts draw attention to specific transactions or specific accounting treatments which could pose potential risks in the audit of the particular client. The Big Four firms use Risk Alerts to better equip themselves to assess audit risks. This could be a tool to be used by international networks to alert member firms about developments in the economy or, developments in specific industries, which can be areas for audit risk. These Risk Alerts need to be updated periodically, preferably on an annual basis, to draw attention to new national and international developments and also to specific industry phenomena.

As auditing moves more into exercising judgment on assumptions made in financial statements there is a distinct move in auditing from assessing historical data to assessing evidence relating to probabilities. Risk Alerts play a very vital role in this paradigm shift in the audit profession.