Solutions to Student Self Assessment Questions

Chapter 20

Criticisms and developments in auditing

20.1 We give below a number of issues that might be discussed when answering this question. A useful starting point is to distinguish between business failure and audit failure. Business failure occurs when a company is in financial distress and has gone into bankruptcy or is close to going out of business. It can occur for many reasons, for example, failure to innovate, unable to compete with more efficiently and effectively managed companies, the failure of a large project which places strains on the company's finances, engaging in high risk and complex financial transactions and so on. The prime responsibility for failures of these sorts lies with management. Audit failure arises where auditors fail to detect material misstatements in the financial statements. These misstatements may arise from errors when the financial statements are prepared. However, the misstatements may be deliberately perpetrated by management to hide or conceal significant risks being incurred by the company or poor financial performance. It would seem unreasonable to blame auditors for a company being forced into bankruptcy because it has suffered a period of poor performance and this has been appropriately disclosed in the financial statements. Complications arise when the management of a company selects policies or makes disclosures where there may be some intent to conceal the 'true' performance of the company. As you may remember from earlier chapters the nature of the term 'true and fair' view is not well defined and therefore alternative configurations of the financial statements are possible, all of which might show a true and fair view. What has to be determined is when the policies selected or the judgments used by management are such that the financial statements no longer show a true and fair view. In the latter case one would expect auditors to have modified their audit opinion and if they have not done so they are more likely to be guilty of audit failure and perhaps of negligence. There is considerable scope for the exercise of judgment all of which take place at a particular period of time when the auditor does not know how the future will turn out. It may be that management in undertaking certain risky transactions should have been made this clear in the disclosures in the financial statements. But what if management made the disclosures that are required of them by accounting standards and the companies act and made what disclosures they thought were necessary at the time given the risks they thought they faced; are the auditors then guilty of audit failure because they should have foreseen the possibility of future hazards.

It can as we hope to have shown above be difficult to determine where there has been audit failure. It is important that this is done so that where auditors are at fault for not disclosing some misstatement or not modifying their audit report that they are subjected to appropriate disciplinary procedures. When a company fails it is also important to consider that the facts known and the judgments taken were with the information available at the time and that the auditors do not have the benefit of hindsight.

It is likely that when a company fails the media is quick to try and find a scapegoat and sometimes this can be the auditors as well as the management of a company. However, because of the complexity of some of these cases it would be valuable to step back a little and give more thoughtful consideration to whether the auditors were culpable. This may require a much more thorough consideration of the nature of and facts surrounding the failure of a company than is often given in the media.

20.2 In response to this question you might have made the following points:

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Power has identified and opened up a debate about the increasing and varied use of the term 'audit'. This in itself is a useful exercise because it causes individuals to reflect upon the practices they are either involved in or affected by. In addition, his thesis that the increased use of audit has been caused by three main factors, is one that raises particular issues about accountability and regulatory compliance. His contention that having an audit is more important than the actual practices forming an audit is an issue which would benefit from further investigation. The significance of his proposition that audit is more concerned with testing controls and systems rather than the direct testing of transactions and the implications of this is also an area that is worthy of further exploration. Finally, his questioning of whether the increase in audit has actually led to greater accountability and democracy raises important issues about the way in which society is structured and the role of trust in that society.

Although Power has not actually set out a program of reform for the audit profession or indeed the role of audit in society he has identified and discussed a number of issues that should provoke debate. However, critics of his work might suggest it is too abstract and lacking in actual specific suggestions for it to be a useful stimulus for reform of auditing.

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