Watchdog or Bloodhound?  
The Push and Pull Toward a New Audit Model

By Deepak Sarup, CISA, FCA

More than 100 years have elapsed since the Court of Appeal in England delivered a landmark judgment in the Kingston Cotton Mills case. The facts were reasonably simple and not contended by the parties. The company’s managing director, who subsequently confessed the frauds he committed, had falsified its accounts. In particular, the quantities and value of the company’s stock had been falsified for many years but there was nothing on the face of the accounts to excite suspicion. It was suggested to the court that the auditor should not have relied solely on the representation of the managing director and should have further investigated the matter. In a unanimous judgment, the three Lord Justices reversed the decision of the lower court and found in favor of the auditor:

“It is the duty of an auditor to bring to bear on the work he has to perform that skill, care, and caution which a reasonably competent, careful, and cautious auditor would use.

An auditor is not bound to be a detective, or, as was said, to approach his work with suspicion, or with a foregone conclusion that there is something wrong. He is a watchdog, but not a bloodhound.

Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud, when there is nothing to arouse their suspicion ... So to hold would make the position of an auditor intolerable.”

—Lord Justice Lopes

Regarding Kingston Cotton Mills (1896)

In this famous judgment, Lord Justice Lopes, perhaps unintentionally, shaped the very ethos of the audit profession for the next century. In the watchdog mindset, the profession adopted a passive approach to an audit, together with an implicit presumption that the representations made by management could be, and indeed should be, relied upon. Yet, whatever the merits of this philosophy 100 years ago, the audit profession is increasingly seen as having failed to meet the public interest, particularly over the last few years. The flood of recent corporate failures and the sad demise of one of the Big 5 audit firms attest irrefutably to the flaws of the watchdog-driven audit philosophy.

Has Self-regulation Failed to Meet the Public Interest?

As with many other professions, the audit profession prides itself on being largely self-regulating. This modus operandi is increasingly under attack as the profession attracts, fairly or unfairly, some of the blame for the recent corporate failures and the consequent losses to the investing public, the thousands of innocent employees and suppliers, and a multitude of other stakeholders.

At Enron, the starting point for these recent failures, the profession tried, unsuccessfully, to rationalize the patently failed audit. The complexities of Enron’s business model and the appearance of compliance with the accounting rules for “special purpose entities” offered some mitigation. On the other hand, the circumstances of the multibillion-dollar fraud at WorldCom are hard to even attempt to rationalize. The transfer of lease payments for use of third-party networks, from expenses to capital, is something that is “taught in the first few weeks of a core financial reporting class. That is why people are asking, given its basic nature and its magnitude, how could it have been missed.” The alleged frauds at Tyco International, Adelphia Communications, HealthSouth Corp. and Dutch retailing giant Ahold NV all beg the same questions: What were the auditors doing? Is the audit approach fundamentally flawed? Is the current audit model broken? Has self-regulation failed?

For the auditing profession, the unfolding events herald a strong pull away from self-regulation. Indeed, new legislation has sought to curtail this power aggressively. For example the Sarbanes-Oxley Act in the US, among others, restricts the ability of an accounting firm to provide nonaudit services to an audit client and establishes an independent oversight board with powers to sanction errant audit firms. Similar regulatory efforts are under consideration in many other jurisdictions.
Some within the profession view these reforms as a knee-jerk reaction by regulators designed more to pacify the investing public than pursue serious change. Perhaps so, but is it not timely for the audit profession to take a long and hard look at its state of affairs and urgently pursue appropriate and deep-rooted change?

Primary Issues to Address

1. Not just independent, but clearly seen to be so: Much of the public debate in recent years has centered on the independence of the audit firms or, more precisely, lack thereof. This perception arises from the multiple relationships that the audit firms had developed with audit clients. Indeed the nonaudit relationship had often exceeded the fee value of the audit itself. Not surprisingly, this situation was viewed by many outside the profession as creating serious conflicts of interest that may have conceivably clouded the auditor’s judgment in the formation of an opinion on the financial statements.

The independence issue has been aggravated by the increasingly entrepreneurial management style of audit firms. In some cases, the audit was viewed as just one of many assurance-type services provided by a firm. Also, given stiff competition, the audit relationship was at times viewed as a loss leader, and the engagement audit partner was under severe peer pressure within a firm to leverage the audit relationship to develop other fee-based services. This cozy audit-client relationship may well have allowed some of the recent corporate collapses to remain undetected longer than necessary.

The case for change may seem obvious to the public at large but the profession has vociferously resisted any significant change. The defense has been ingenious. As one of the leaders of the profession notes, “one of our major aims has been to explain effectively why enforced separation of audit and nonaudit work, where other safeguards against loss of independence are available, would result in loss of audit quality.”4 It may seem that, left to itself, the profession will, in its view, be able to continue to resist calls for more independence; hence, the rush by the regulators to act, to meet the public interest demands.

2. Comprehensive standards, but not as a substitute for audit judgment: In reaction to the ever-increasing litigation battles, the auditing profession has pushed for rigorous and comprehensive accounting standards that better prescribe the rules for the preparation of financial statements. Indeed, standards have become more voluminous and lengthy. For example, in one estimate the roughly 2,300 pages of Financial Accounting Standards Board (FASB) standards that existed in 1985 doubled to around 4,000 by 2002. But, as reflected in the Enron scandal, compliance with the mere form of the standards was not enough. Similar hurdles have been encountered when dealing with executive compensation, pension accounting and revenue recognition, where the thrust of the audit has been to seek compliance with the form rather than the spirit of the standards.

Accounting academics have started to point out the pitfalls of an overreliance on standards. According to Harvard Business School professors Paul M. Healy and Krishna G. Palepu, this push for standardization will enable “auditors to abdicate responsibility as processors of information.” They add that “the auditors’ statement that a company’s accounts have been prepared in accordance with generally accepted accounting principles no longer implies, as it once did, that auditors have made the kind of broad judgment about the financial health of a company that investors need and expect accountants to provide.”5

The profession urgently needs to reexamine its push toward a checklist-centric audit approach, when auditing was and remains, at best, more an art than a science. Standards have their place and importance but not as a surrogate for exercising audit judgment.

3. The need for greater responsibility for detecting fraud: From the time of the Kingston Cotton Mills case to the present day, the auditing profession has resisted demands to revisit either the watchdog mindset or the patent overreliance on the representations made by management. The prevailing view remains that “audits are not designed to detect management fraud. This can be done, but it is a more expensive and time-consuming process.”6 This view of the audit model ignores both the public interest argument and recent judgments, which have tended to adopt a broader view of auditors’ accountability for their work than Lord Justice Lopes was inclined to do 100 years ago.

In fairness, the profession has started to respond to the public clamor for a broader audit responsibility and has reluctantly accepted that auditors must consider fraud in an audit of financial statements. The current exposure draft of the revised International Auditing Standard on this subject requires auditors to “maintain an attitude of professional skepticism’ recognizing the possibility that a material misstatement due to fraud could exist.”7 Although this standard does not require an auditor to be a bloodhound, it does seem to move well beyond the parameters of just being a watchdog.

Toward a New Audit Model

The audit profession has a choice. It can either let the regulators take the lead and pull the profession to a new audit model, or it can bite the bullet and adopt an aggressive change agenda to push itself to a new model. Presented below are three options that merit further consideration by the profession.

1. A push to move beyond GAAP: Billionaire investor Warren Buffet has been a longtime critic of the accounting profession and Wall Street for their roles in the decline in corporate ethics. In a recent press conference, the investment guru was reported as saying, “You would be amazed how compliant auditors have been in the past decade, not only cooperating but suggesting techniques for making numbers less useful—less truthful—to investors.”8

In his view, the crux of the problem is with the fixation of accountants and auditors with statements based on the Generally Accepted Accounting Principles (GAAP). Buffet
believe that “what needs to be reported is data—whether GAAP, non-GAAP or extra GAAP—that helps financially literate readers answer three questions:  
• Approximately how much is this company worth?  
• What is the likelihood that it can meet its future obligations?  
• How good a job are its managers doing, given the hand they have been dealt?

In most cases, answers to one or more of these questions are somewhere between difficult and impossible to glean from the minimum GAAP presentations.”

To move to a more holistic report on past financial performance, somewhat akin to the internal financial data most companies use to run their business, would require a seismic shift in the audit approach, coverage and cost. While the shift away from the mechanical GAAP reports may represent a radical change to the audit model, it is nevertheless an option that warrants serious consideration by the profession. Given the diverse range of industries covered by the profession, it will require a level of knowledge and specialization that simply does not exist in adequate numbers today within the larger firms. However, if pursued successfully, it will dramatically improve the quality and usefulness of the financial information that is available to the public.

Meanwhile, the standard setters for the accounting profession have recognized the need to shift away from setting detailed rules and are pulling toward establishing broad-based principles. Another major reported shift by this group is to move away from reporting assets and liabilities at historical cost less depreciation and to force companies to value assets and liabilities at market prices. These changes will result in more meaningful financial statements although the underlying profits will, no doubt, be much more volatile. Sir David Tweedie, chairman of the International Accounting Standards Board, notes that the new standards will strip “away management’s ability to massage their numbers.” While all this may not be quite as far as Buffet would like the profession to move, the new standards, when available, may address some of the shortcomings of GAAP and will no doubt require a more rigorous audit approach than may be the practice today.

2. A push to take the bias out of the audit model: In a recent paper, Harvard Business School professor Max H. Bazerman and two other prominent academics make a case that the root cause of the profession’s problems rests with the innate and unconscious bias in today’s audit model. They note that “because of the tight relationships between accounting firms and their audit clients, even the most honest and meticulous of auditors can unintentionally distort the numbers in ways that mask the company’s true financial status.” The professors add, “even seemingly egregious accounting scandals, such as Andersen’s audit of Enron, may have at its core a series of unconsciously biased judgments rather than a deliberate program of criminality.”

This view is predicated on the belief that improved GAAP and the recent legislation will not eliminate the opportunities for bias to influence audit judgment. They contend that the inherent ambiguity of accounting decisions, the natural desire to foster good client relationships and the negative consequences of critical audit reports will perpetuate the self-serving audit bias, where the auditor unconsciously discounts facts that contradict the preferred position and uncritically embraces facts that support this position.

Professor Bazerman suggests that reforms such as the Sarbanes-Oxley Act will fail to restore confidence in the audit. Accordingly, he recommends a shift to a more independent audit model based around the following principles:
• A requirement for audit firms to divest all consulting and tax services
• Appointment of auditors for a fixed and limited term but without any termination provisions and with a predetermined fee for the whole term
• Prohibition on companies from rehiring audit firms at the end of the contract
• Prohibition on companies from hiring individual accountants away from its audit firm
• Education of auditors on the possibility of unconscious errors and the reason that they may arise

While this new model represents a radical remedy and is by no means perfect, it seems to be a much better approach than the half-hearted reforms that are currently underway. If this model were to be adopted, the audit-client relationship would take a paradigm shift away from today’s advisory or business partner nature to a more arms-length relationship that companies typically have with, say, regulators or tax collectors.

3. A push toward quality: It is somewhat axiomatic that to meet the public interest there needs to be a determined effort to provide better quality audits. Professors Healy and Palepu believe that while the regulatory changes are a step in the right direction “they do little to motivate companies to pay significantly higher fees for higher quality audits.” On the contrary, the worse the situation of the company, the less reason for its management to give the auditors that extra leeway to do a better job.

The professors believe that the only way to restore the credibility of the profession is to “completely redefine the lines of communication and responsibility in auditing.” In particular, they argue that there is an urgent need for some neutral third party, e.g., the stock exchange, to play a pivotal role in monitoring the performance of the audit. This new model should be built around the following four elements:
• The auditors would provide a definitive report of their findings and responses from management to the audit committee of a company and, on a private basis, the stock exchange.
• The current “black and white” audit opinion on the financial statements would be replaced by a public and standardized transparency rating—similar to the credit rating given to bonds. This would allow the users of the financial statements to better assess the quality of the financial statements.

• The stock exchange would have a broad role in determining the scope of the audit, fees and the standards to be followed. They would also investigate the causes of future audit failures.

• The audit fee for engagements would be covered through a special levy on, for example, stock trades, and professors Healy and Palepu believe that the additional levy would not only be nominal but well worth any additional expense if some of the audit failures could be avoided.

This proposed new model is perhaps the most radical of the three options discussed. It does, however, address the critical need for improved quality and the motivation and framework for the auditors to meet this demand. To potential critics, the professors point out similar control models in other industries. For example, the US Federal Drug Administration and the US Federal Aviation Administration work well in controlling safety and quality in the pharmaceutical and airline industries.

Conclusion
The audit profession stands at a major crossroad. It can continue with business as usual and await, with near certainty, the consequences of the next major audit disaster and yet more pull by the regulators toward a new and better audit model. Alternatively, it can embrace the need for radical reform and push itself toward a new, improved audit model that provides motivation for better quality audits; ameliorates, if not eliminates, the self-serving audit bias; and goes a long way towards addressing the public interest.

In the famous pitch to persuade Brutus to join the conspiracy to destroy the imperial ambitions of Caesar, Cassius stated:

Men at some time are masters of their fates:
The fault, dear Brutus, is not in our stars,
But in ourselves, that we are underlings.  

Perhaps it is time for the audit profession to stop blaming its “stars” and move beyond the passive philosophy espoused in the judgment of Lord Justice Lopes. Indeed, it is time for the profession to be master of its own fate and push a radical reform agenda that will meet the public interest.

Endnotes
1. The Law Times, Volume LXXIV, Court of Appeal, 11 July 1896
2. Nelson, Karen; Stanford Graduate School of Business, Knowledge@wharton, July 3, 2002
3. Peter Wyman, President, Institute of Chartered Accountants in England & Wales, Annual Review, 2002
4. Ibid.
6. Eccles, Robert G.; PricewaterhouseCoopers, Knowledge@wharton, 25 September 2003
8. Reuters, May 2003
12. Ibid.
14. Shakespeare, William; Julius Caesar

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