# Why Audit will Continue to Fail!

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# *Why Audit will Continue to Fail!*

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## Background

The Wirecard €1.9 billion missing cash and 3.2 billion debt scandals have ignited the conversation about audit complacency in the financial reporting process. Financial statement fraud, audit failures and the sudden collapse of companies without any warning signs have increased in size and occurrence recently, and Wirecard is another example of this. While we were still anguishing on the Wirecard scandals and the inability of their auditor to pick up this material fraud, then came Lookers, the UK car dealership company, and the revelation of it overstating its profitability by £25.5 million (Campbell, 2020).

Financial statement fraud is not new. This list is unending when we talk about financial statement fraud. Management has always deployed different techniques to portray a good outlook for their companies through manipulations of financial statements. This can be dated back to the Royal Mail Steam Packet Company scandal of 1931, to Equity Funding scandal 1973, down to Polly Peck 1990. Enron happened in 2001, Madoff in 2008, Olympus 2011, Tesco 2014, Toshiba 2015, and Patisserie Valerie in 2018 (Awolowo, 2019).

This kind of occurrence is a severe threat to the integrity of financial reporting and corporate governance systems (Hogan, et al., 2008; Smith & Crumbley, 2009; Bhasin, 2013) and often results in a loss of confidence in the financial reporting process by investors and other stakeholders (Hogan, et al., 2008; Smith, 2015).

The impact of financial statement fraud of any scale is enormous on the stakeholders, and related losses are in billions of dollars. The Association of Certified Fraud Examiners

 

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report to the nation on occupational fraud and abuse (2020) estimated that the median loss to financial statement fraud is $954,000.

The negative impact of financial statement fraud is not only threatening the going concern of the company but also impacting other stakeholders in various ways including, but not limited to, loss of jobs and pensions, reduction in stock prices and shareholders' values, and corporate reputational damage (Colby, 2013). Furthermore, financial statement fraud was a significant contributor to the global financial crisis of 2008 (Black, 2010). Financial statement fraud threatens both debt and capital markets' efficiency, liquidity, and safety (Black, 2010).

Fraudulent reporting will most likely increase in occurrence due to the global pandemic caused by COVID19 as companies try to portray a good outlook and, in the process, may "sugarcoat" their annual report.

Financial statement fraud is a form of "occupational fraud" (ACFE, 2016), which involves the *"deliberate misrepresentation of the financial condition of an enterprise accomplished through the intentional misstatement or omission of amounts or disclosures in the financial statements to deceive financial statement users"* (ACFE, 2018).

The aftermath of the Enron accounting scandal saw the Chair of the Board and President of the American Institute of Certified Public Accountants issued the following joint statement: *"Our profession enjoys a sacred public trust and for more than one hundred years has served the public interest. Yet, in a short period, the stain from Enron's collapse has eroded our most important asset: Public Confidence"* (Castellano & Melancon, 2002, p. 1).

Sadly, for the past 500 years, accounting and auditing concepts have not changed (Silverstone, et al., 2012). In this age of information revolution, the accounting profession still relies on an audit technique that was utilised before the industrial period. The reliance on this industrial age audit technique has resulted in an unrelenting series of embarrassing financial statement fraud and audit failures.

## Auditing Profession is in Denial

The auditing profession's prevailing wisdom is a complete denial of the responsibility to detect fraud in the financial statement. This denial is evident in the International Standard on Auditing (ISA) 240, which places the responsibility for preventing and detecting fraud solely on those charged with the management and governance of entities. This denial makes one wonder what auditors' role is in reducing information asymmetry, which is evident in an agency relationship between shareholders and the management (Awolowo, 2019).

Nevertheless, this denial has not stopped financial statement fraud from occurring. Neither has it prevented the profession from being heavily criticised and questioned by stakeholders

 

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after any revelation of fraudulent financial reporting. The first question the business community is always quick to ask after any fraudulent financial reporting announcement is **who are the auditors?** (Awolowo, et al., 2018)

Nowadays, the frequency at which corporate entities collapse because of financial statement fraud has raised a serious question on whether the current accounting system of reporting and financial controls is working (Smith & Crumbley, 2009; Garrow, et al., 2019). We witnessed Patisserie Valerie's collapse into administration in early 2019 due to financial statement fraud (Uttley, 2019).

Stephen Griggs, a senior managing partner at Deloitte UK, made the following remark in The Times newspaper on the 2nd of April 2019: "For many years we have talked about the role that auditors play in providing trust and confidence in the capital market. Yet audit has not moved with the times. We need to do more to evolve it to meet the expectations of all stakeholders."

The amount of money the Big Four audit firms have paid in fines between mid-2017 and mid-2019 is enormous. If auditors do not have responsibility for detecting fraud in the financial statement, how come they are always quick to be fined by regulators after any revelation of financial statement fraud. Table 1 below shows the fines paid by the Big four audit firms.

 

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| Name of Audit Firm | Year | Fine | Company Involved |
|---|---|---|---|
| KPMG | 2019 | £5M | Co-operative Bank audit |
| KPMG | 2019 | £12.5M | BNY Mellon |
| KPMG | 2019 | £6M | ESM Limited |
| KPMG | 2019 | £6M | Equity Red Star |
| PWC | 2019 | £4.6M | Redcentric |
| Deloitte | 2019 | £4.2M | Serco |
| PWC | 2018 | £5.1M | RSM Tenon |
| KPMG | 2018 | £2.1M | Ted Baker |
| KPMG | 2018 | £7M | Lloyd's of London underwriter |
| PWC | 2018 | £6.5M | BHS |
| KPMG | 2018 | £3.2M | Quindell |
| PWC | 2017 | £5M | Connaught audit |
| KPMG | 2017 | £4.8M | Miller Energy audit |
| EY | 2017 | £1.8M | Tech Data audit |

Table 1: Fines paid by BIG FOUR between late 2017 - 2019

Another interesting dimension to this is that auditors are usually the first set of people to lose their job after any revelation of fraudulent reporting. Such was Tesco's case which ended their 32 years audit relationship with PWC after the announcement of their accounting scandal in 2014 (Awolowo, et al., 2018). Lookers have equally announced that they are ending their audit relationship with Deloitte due to their accounting scandal.

In Japan, Olympus changed its auditor from KPMG AZSA LLC to Ernst & Young Shin Nihon LLC immediately after Michael Woodford exposed the most prominent corporate scandal in Japanese history in 2011 (Aubin & Uranaka, 2011). The same happened to Toshiba, who also changed their auditor from Ernst & Young ShinNihon to PWC Aarata after the company was found overstating its profit by $1.3 billion in a fraud that spans over seven years

 

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(Inagaki, 2017). The issue then is, if auditors are not responsible for detecting fraud in the financial statement as they claimed, how is it that companies are usually quick to end their audit relationship after any revelation of fraudulent reporting?

This suggests that the business community demands auditors and the accounting profession to improve their fight against financial deception. However, this is somewhat difficult with the current accounting system and reporting and procedural auditing culture. Hence, the need for a system shift to forensic accounting.

## Forensic Accounting

ACFE defined forensic accounting asthe use of professional accounting skills in matters involving potential or actual civil or criminal litigation, including, but not limited to, Generally Acceptable Accounting Principle; the determination of lost profit, income, assets, or damages; evaluation of internal controls; fraud; and any other matter involving accounting expertise in the legal system.

Forensic Accounting can simply be put as the use of accounting for legal purposes (Hopwood, et al., 2012). We defined forensic accounting in the context of financial statements as a high-level validation of financial information through an array of skills involving but not limited to accounting, auditing, law, criminology, psychology, economics, computer science in actual civil or criminal investigation.

Joshi (2006), emphasising the relevance of forensic accounting in fraud prevention and detection, observed that "auditors should be a watchdog and not be the bloodhound." This quote alone makes forensic accounting definition even simpler and helps differentiate a forensic accountant from other accountants and auditors. A forensic accountant is a bloodhound of bookkeeping (Crumbley, 2009).

These bloodhounds 'sniff out' fraud and criminal transactions in banks, corporate entities or from any other organisation's financial records. They 'hound' for the conclusive evidence. External auditors are known to only find deliberate misstatements, but forensic accountants deliberately find out misstatements. External auditors look at the numbers, but forensic accountants look beyond the numbers (Joshi, 2006). These are some of the attributes that make forensic accounting relevant in the fight against financial deception.

## Conclusion

Our conclusion is that until present-day auditors are trained in forensic accounting skills, ethics, and principles and start acting like detectives, the way and manner in which fraud

 

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is hidden in complex financial transactions will continue to threaten the integrity of financial reporting corporate governance. For the auditing profession to avoid more casualties in terms of audit failures and the corresponding fines that come with it, now is the time to evolve audit and embrace forensic accounting and accept fraud detection responsibility in the financial statement. Until this is done, audit will continue to fail and not too long from now, and it might become irrelevant to the capital market if the recommendations of the Brydon report are implemented.

 

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