The future of auditing

A vision from the US

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(Adapted from 'Reinventing the Audit,' by Robert Mednick, Journal of Accountancy, August 1991. Copyright 1991 Arthur Andersen & Co.

The accounting profession desperately needs a process for completely reengineering the audit function and regaining the public's confidence. Recent business failures have brought on growing criticism of the profession and repeated demands of 'Where were the auditors?' There is a clear need to accelerate the current pace of change. We need to show - forcefully and unequivocally - our commitment to meet changing public expectations and create new levels of value for the audit process.
Obviously, the required changes and innovations cannot be achieved overnight. We can, however, develop a framework within which such changes can take place and begin the process by attacking the items that seem most pressing and capable of relatively rapid implementation. This article is designed to do both - by outlining a general framework for change and suggesting priorities for immediate action.
In considering these issues, I have sought and obtained the advice and counsel of a number of senior partners of my firm. Our free-form discussions adhered to a few simple rules; the most important one was that no sacred cows would block the path to new ideas. In addition, we decided early not to be inhibited by concerns over liability or whether practicing auditors today have the requisite skills (though proposals for enhanced training and various tort reform initiatives must be included in the process of change).
What we did specifically attempt to do was look at our profession and its work form the perspective of others - to climb out of our own mind-sets and consider innovations that users of our reports would welcome. Furthermore, as partners in an international professional services organization, we sought solutions that made sense globally, while recognizing the exact nature and timing of their local implementation would vary from country to country.
Of course, before effectively reinventing the audit function, one must first identify what is wrong with auditing and financial reporting. In my view, deficiencies can be classified into four broad categories:
- The current accounting model is becoming irrelevant.
- More is expected of auditors than an opinion on financial statements.
- The concept of audit independence needs to be refined and clarified.
- Auditors are inhibited by the realities of litigation.

It is these problems that must be addressed in developing a new framework for financial reporting and the attest function for the last decade of the 20th century and beyond.
The continuing need for quality audits as redefined is clear from several aspects of our increasingly complex and global economy. First, there is a growing need and demand for accountability in all aspects of society. Second, there is a continued trend toward the global composition of debt and equity ca-

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pital which is arranged and marketed without regard to national boundaries. Finally, and most important, there is the rapidly changing face of the corporate governance model, particularly in the United States, United Kingdom and other English-speaking countries, which should enhance the profession's ability to carry out the attest role in a manner most consistent with its public interest responsibilities.

Corporate governance and auditor responsibilities

Understanding the relationship between corporate governance and the independent auditor's responsibilities is key to any redefinition of the attest function. In today's business world, an entity's board of directors and management are fully responsible for running the business and periodically reporting its status and results to the entity's various stakeholders. Stakeholders include current and potential investors, depositors, creditors, employees, government agencies and the public generally. In different ways and for varied purposes, they all use such information in making investment and other decisions.

But where does the accounting profession fit into this model?

I believe auditors can, by virtue of their training, history and orientation, best serve society as the premier suppliers of worthwhile information to managements, boards of directors and stakeholder groups. With the explosion of affordable information in recent years, a significant premium has been placed on the work of those professionals who can analyze, organize, validate and present information in useful and timely ways. These skills are virtually synonymous with auditors traditional expertise in gathering information, analyzing numbers, developing hypotheses, verifying and evaluating facts and evidence and summarizing and communicating findings.

Under today's definition of the attest function, however, the auditor is responsible only for opining objectively on the board's and management's periodic reports to stakeholders, based on established standards and rules for such reports (such as generally accepted accounting principles). Ideally, a future auditor should be directly responsible to the stakeholders for all knowledge gained in an engagement they would find useful in their decision making. Of course, there will be great practical difficulties in communicating information directly, comprehensively and in a timely manner to hundreds of thousands of stakeholders. Consequently, in moving toward this ideal, the auditor will need to develop close working relationships with representatives of various stakeholder groups. For many, this will be primarily the entity's board of directors. Other groups also could include, however, creditors'committees, labor unions, banking regulators and others. (The authority and fiduciary responsibilities of such representatives, also of crucial importance, are discussed further below.)

As a first step along the road to the ideal, the profession will probably merely supplement the traditional opinion on management's assertions for example, with an independent financial analysis of the entity and early warnings of potential problems, communicated in most cases to the stakeholders' representatives. In the long run, however, auditors will need to find new and better ways, including the use of leading edge database technologies, to communicate directly and more completely with many kinds of stakeholders.

Because the various stakeholder groups are farthest form the seat of power and decision making our principal responsibility as suppliers of worthwhile information is to them. When stakeholders' interests conflict, the auditors' first responsibility must be to those by whom or on whose behalf they were engaged. It is not inconsistent, however, to serve simultaneously as the principal providers of information (including a critical financial analysis of the entity) to management and the board. In fact, not to do so would be totally contrary to the interests of the stakeholders and society as a whole.

In theory, auditors should be hired and fired by the stakeholders, to whom they are primarily responsible. In practice, this function – or at least some form of ratification or confirmation – might best be left to their representatives, generally the board. This also suggests that, before auditors can resign, they need to be sure they have fully communicated all they know to the stakeholders, either by competing the audit or by making such disclosure in connection with the resignation.

Changes in corporate governance could make audits more valuable

At present nothing in US law requires that directors be independent of management. Furthermore, while most large companies now have audit committees made up primarily of outside directors, the committees' role and powers are not well defined. Most serve mainly as a communications link between the board of directors and the independent auditor without any formal requirement for an independent review of the financial statements and auditor's report. To make US audit committees more effective monitors of public corporations, it probably will be necessary to strengthen formally the outside directors' independence from management and to enhance their role and power.

While some will react skeptically to this idea, in reality the United States and United Kingdom may be closer to such a shift in responsibility than many realize. See for example the recommendations from the committee on financial aspects of corporate governance (the Cadbury Committee) in the UK (Draft report, 27 May 1992).

This change is driven by a new generation of institutional investors that recognize they have no choice but to participate more actively in the corporate governance process. These 'professional owners' will require a broader, independent assessment of management's stewardship and will focus increasingly on the board of directors - as well as independent auditors - to conduct it. Consequently, even without a legislative requirement for independent oversight of management, boards of directors are likely to become more independent and active as they grasp fully their fiduciary responsibilities to shareholders and other affected stakeholder groups.

This development should add immeasurably to our profession's ability to create a more valuable attest function. But to achieve full value, we must also begin to think and act globally in an increasingly global marketplace for goods, services and capital. The tremendous growth in cross-border capital movements has forever changed the shape of the world economy and the role that accountants must play in it if we wish to remain a valued part of society.

How auditors cope in the new world economy – particularly those who are directly involved in multinational security offerings – can only be touched on briefly in this article. It is clear, however, that this will require new skills, more education in international business and finance, new forms of on-the-job training, and increased cooperation with other professionals around the world. It will also require an acceleration of the recent progress made toward the international harmonization of accounting, auditing and financial reporting standards.

Proposed solutions to the four basic deficiencies in auditing and financial reporting cited earlier and reiterated below are described in the remainder of this article:

- The increasing irrelevance of the current accounting model.
- The desire for more from auditors than an opinion on financial statements.
- The need to refine and clarify the concept of audit independence.
- Inhibitions caused by growing civil liability.

Each of these solutions, while fully capable of separate implementation in the US and other countries, should also be considered within the broader context of our increasingly global economy and the ultimate role of auditors in it.

An increasingly irrelevant accounting model

People are increasingly looking to sources other than current financial statements for useful information, principally because such statements are limited to past transactions, prepared in nominal dollars and based primarily on historical costs. Further, financial statements offer only limited, spotty disclosures of risks and uncertainties or the factors on which the company's future success most depends. These are, in my view, major reasons for the so-called expectation gap that has drawn so much criticism to the profession in recent years.

Yet, despite occasional assertions to the contrary, I believe investors and others want and expect more: more predictive and value-based information; more of the whys - not simply whats - of financial data; and more early warning that a company is making poor decisions or may be nearing the brink of financial collapse.

The limited scope of financial statements also is the

reason why, in my view, two thirds of the respondents to a 1985 Lou Harris & Associates survey for the Financial Accounting Standards Board agreed that 'qualitative information presented outside the financial statements, such as management observations, strategic plans and goals, market growth, etc., often can be more useful than quantitative measures included in the financial statements.' Even the FASB's conceptual framework acknowledges traditional financial statements are useful only to the extent they help discern trends and predict the future.
The problem is, in today's extremely fast-changing world and economy, historical trends often are no longer very good measures of likely future performance. This reality tends to make historical, cost-based financial statements, like the horse and buggy, anachronistic.

The solution to this problem is fairly evident. Achieving it will not, however, be easy. In the long run, it will require, among other things, the inclusion of forecasts and projections in the general-purpose reporting package and a shift to value-based financial statements. In the interim. we need to increase the disclosure in financial statements of data that might provide better indication of future results, such as order backlogs, new product development and competitive position. We also need to encourage more in-depth management discussion of future prospects-located, for example, in directors'reports in the United Kingdom and management's discussion and analysis (MD&A) in the US The MD&A already is supposed to 'focus specifically on material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or future financial condition.'

As another intermediate step, the profession can and should encourage supplementary current value financial statements for companies in at least some industries (such as real estate) and require more disclosure of current value information in the footnotes to financial statements (as recently required by the FASB for financial instruments). At the same time, we should insist on more disclosure of the risks and uncertainties facing a company, such as those cited in a 1987 report by an American Institute of CPAs task force on risks and uncertainties and those regularly contained in the risks section of registration statements in the US.

These interim steps would start us on the road to significant change. For the longer term, we need to accelerate work on a completely new information model and actively encourage companies to experiment publicly with that model during the development stage. Such a model would include not only more meaningful financial disclosures but other indicators - in fact, producers - of long-term earnings and value. Performance measures such as market standing, customer satisfaction, product quality, cost and productivity and management and worker performance would clearly be an important element of this new information age accounting.

Greater expectations than an opinion on financial statements

Even with an improved accounting model, the public has grown to expect more of auditors than merely an opinion on management's assertions. Among other things, stakeholders want auditors to improve their ability to detect management fraud and to provide an early warning of possible business failures or setbacks. In addition, they increasingly look to the profession for assurance the entity is well controlled and has complied with appropriate laws and regulations. Finally, the public wants to be able to look to auditors for an independent, critical financial analysis of the entity's results and prospects.

Again, all these measures are within our reach although their implementation may take some time, at least in certain countries. Specific steps that could generate immediate results include new and expanded training and methodologies for spotting high-risk situations. For example, as part of improving their ability to detect management fraud, auditors could research more thoroughly the backgrounds and character of managements, directors underwriters, etc., of both new clients and, when there is a change in control or management, existing clients. With respect to providing more early warnings, expanding the disclosure of risks and uncertainties obviously should help. In addition, I recommend requiring a separate auditors' report on directors' reports and on MD&A – with their greater orientation to the future – as well as a requirement to perform and publicly report on reviews of interim financial information.

Expanded auditor involvement with controls, including those over compliance with laws and regulations, is another area ripe for a major breakthrough soon. In the United States, for example, a new requirement for both management and auditor reports on internal controls of insured depository institutions will become effective next year.

Finally, I believe auditors can and should regularly provide an independent, critical financial analysis of the entity at least to the board of directors, as the representatives of shareholders and other stakeholder groups. Unfortunately, today auditors' special skills in financial analysis often are not fully exploited in advising boards –as well as managements– of problem areas that exist or are likely to arise and that require special attention. From my own experience, auditors communicate critical and sensitive information more effectively in a purchase investigation for a prospective acquirer of a business than in a traditional annual audit. Such a critical financial analysis, however, must become a regular part of communication with boards of directors as soon as possible.

Independence as a concept needs clarification

Independence is the cornerstone of the accounting profession and one of its most precious assets. It also is the only sound basis for an ongoing relationship with a client. Nevertheless, an auditor's independence is difficult to prove and easy to challenge. For that reason, most accounting firms have developed controls specifically aimed at assuring their professional independence in both fact and appearance.

Unfortunately, independence may not mean the same things to accountants as it does to others. Because of this, professional and regulatory bodies - particularly in the United States - have tried to define the term through a series of rules and regulations that have grown wildly during the past decade. We are in serious danger of losing sight of the forest for the trees.

Lost in a thicket of minutiae, we need to get back to basics. Independence is first and foremost a state of mind. A deeply felt professional credo, it is cultivated by accountants in public practice from their first day in the profession and is emphasized and reemphasized in codes of professional ethics and continuing professional education throughout their careers.

I believe there is a real danger in the current approach to auditor independence.

As in many other areas of life, when rules and regulations grow more minute and arbitrary, individuals and organizations find it easier to avoid making ethical judgments - the tough calls the rules may not cover. We merely comply or fail to comply. But rules, in the final analysis, are hollow rituals unless they have the underpinning of rational supports.

One part of the solution to this dilemma is to emphasize much more strongly professional ethics and the rigorous application of independent judgment to tough financial reporting and auditing issues. Regulators, educators, firms and the profession generally must instill and nurture in each auditor a state of mind that makes independence in fact virtually automatic. It is not enough to tell professionals what to do and – more often – what not to do without stressing the reasons why.

Fortunately, the need for a new emphasis has become apparent to growing numbers of participants in the US capital markets. As a result, a special AICPA task force is developing a completely new framework for auditor independence. That task force is establishing basic principles of independence and a mechanism to get advice in dealing with them. Most important, it has intentionally avoided creating new detailed rules. Rather, each firm would create its own policies (based on and consistent with these basic principles), which in turn would then be the subject of regular peer reviews.

I believe this is a major step in the right direction. A code of basic principles will focus attention on the true meaning of independence – the need to act with integrity and objectivity – and could serve as a catalyst for harmonizing the varying standards of independence around the world.

Litigation threatens innovation

I believe all the changes recommended above are necessary to restore value to the attest function and regain the public's confidence in our profession. Unfortunately, progress toward change is very hard to achieve in highly litigious societies. We need to find new ways to mitigate the growing litigation burden on the profession if such changes are to become a practical reality any time soon.

One solution, of course, is to adopt the German approach, which takes a rather restrictive view of the independent auditor's civil liability. This might include capping auditors' liability, possibly at a multiple of a reasonable fee for the services performed. Australia is now discussing such a method, which has passed the parliamentary second reading stage as part of an occupational liability bill.

Other approaches that could be considered to provided equitable relief for auditors include.

- Requiring officers and directors to take out appropriate indemnity insurance.
- Creating safe harbors to compensate for any mandated expansions in auditors' responsibilities.
- Educating key legislators and regulators about the broad economic consequences of further bankruptcies or failures of accounting firms caused by unreasonable exposure to liability due to their 'deep pockets'.
- Permitting accounting firms to incorporate in order to limit the personal liability of shareholder-owners not involved in an allegedly deficient audit.
- Adopting general tort reforms in particularly litigious countries such as the United States.

In the US, the adoption of proportionate liability, in lieu of joint and several liability, would do the most to return balance to our legal and judicial systems. The joint and several liability rule lies at the heart of the deep-pocket syndrome and is a threat to the profession's very survival. It is fundamentally unfair because it imposes disproportionate liability on deep-pocket defendants regardless of their share of responsibility for a specific loss. Since auditors usually are only secondarily responsible for instated financial statements and often are themselves victims of management fraud, proportionate liability would generally limit auditor's exposure to a reasonable level while still holding them liable for their full share of the blame.

A renewed commitment to the public interest

The proposals I've discussed begin to build an integrated framework for responding in a meaningful way to the increasingly serious threats to the accounting profession and its social utility. If we fail to start promptly down this road, I have serious doubts about the future of the attest function. On the other hand, if we can agree on this framework and adopt the immediate measures I've discussed, auditors can demonstrate a renewed commitment to the public interest and meet new needs for more sophisticated business information. This will help to secure a healthy future for the profession, our clients and the stakeholders who depend on all of us.