Why and How Audits Must Change

PRACTICAL GUIDANCE TO IMPROVE YOUR AUDITS

Thomas P. Houck, CPA
This book is dedicated to my late father, Paul W. Houck. He devoted countless hours to helping me become a better writer.
About the Author

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In 1995, Tom created the Audit Productivity Improvement Program℠, a comprehensive training program used by hundreds of top accounting firms to strengthen audit quality and improve efficiency. He also oversaw the development of AuditWatch University℠, a five-level training program for staff auditors.

For more information about the author and about AuditWatch, visit www.auditwatch.com.
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For more than a decade, I have studied how independent auditors fulfill their responsibilities. As the founder of AuditWatch, I’ve had the privilege of serving and observing hundreds of accounting firms throughout the United States and Canada. This includes both big and small firms, and progressive as well as unsophisticated companies.

Based on my experience, there’s no doubt as to what must be done to improve the quality of independent audits. Most importantly, all auditors must be highly trained professionals who display sound judgment while accomplishing their objectives.

Since every engagement is different, the exact approach will vary from job to job. This is why auditors must be capable of designing and implementing the best approach for any given circumstance.

In this book, I identify four crucial areas in which every auditor needs to be proficient:

- Risk-based auditing
- Analytical procedures
- Internal controls
- Technology (specifically, data extraction)

An auditor who fails to master these fundamentals is like a golfer who doesn’t properly hold a club, or a trumpet player who can’t read music. These auditors are unlikely to detect material frauds and prevent the issuance of misleading financial statements.
Preface

Unfortunately, the truth is that most auditors are not sufficiently skilled in these areas. This is a major reason why so many engagement teams implement the SALY (same-as-last-year) approaches that are prevalent throughout the accounting profession.

In addition to higher competency levels, the culture at most accounting firms must change. The best training in the world is of limited value if an organization’s culture fails to support and reinforce the fundamentals of effective auditing.

This book delves deeply into all of these topics, providing specific and practical examples that are applicable to all accounting firms. My recommendations are not abstract or theoretical. At AuditWatch, I’ve seen both large and small clients implement these ideas with great success over the past ten years.

In 2002, the accounting profession was forever changed after a string of financial scandals made the headlines. Unfortunately, a repeat scenario is possible unless accounting firms make the necessary changes in their cultures and offer better audit training for their professionals. This is, by far, the most pressing issue that accounting firms and regulators must address in any efforts to restore and improve the credibility of independent auditing.

I assure you that mastering the concepts in this book is the best way to improve audit quality. In addition, this will produce a positive impact on productivity, client service and the morale of audit professionals. Yes, a win-win outcome is possible for both accounting firms and users of financial statements!

NOTICE TO OUR READERS
As we went to press, the Public Company Accounting Oversight Board had just voted to take control of establishing auditing standards for public company audits. At present, it is not known how this decision will alter the audits of public companies or if there will be a cascading effect on the audits of other companies, but it seems likely that there will be an impact on the audits of non-public companies.
A WAKE-UP CALL FOR ALL AUDITORS
The year 2002 was not a good one for the accounting profession. And that’s putting it mildly!

The profession’s problems started after high-flying Enron Corporation suddenly declared bankruptcy. As shocked investors and employees reeled over the sudden disappearance of vast sums of money, the finger-pointing started immediately. Much of the blame for and anger over the losses was directed at Arthur Andersen, the company’s independent auditing firm. Not only did the once-venerable accounting firm apparently screw up the Enron audit, it then made matters worse by shredding documents related to the scandalous case.

Like it or not, independent auditors became regular features in front-page news stories and banner headlines. The media attention was unprecedented, and criticism of accounting firms rose to near-hysterical levels as new scandals broke and more apparent accounting misdeeds were uncovered in the months following the Enron collapse.

“Where were the auditors?” and “What’s wrong with accounting?” became some of the most frequently asked questions of the year. A *Fortune* magazine article declared:

We used to think [accountants] were wise, honest, and probing, necessary to keep gung-ho management straight. Now it’s clear: They’re not.1
The Wall Street Journal ran numerous stories depicting auditors in a negative light. One front-page article ran under this pointed headline:

How Decade of Greed Undid the Proud Respectability of a Very Old Profession

Remarkably, within just a few months of Enron’s bankruptcy filing, Andersen was essentially driven out of business, and the reputation and credibility of the entire accounting profession had taken an abrupt nosedive. Auditors were the subject of jokes by late-night comedians and scored lower than lawyers in public opinion polls.

Despite these stunning events, a return to normalcy appeared likely in the spring of 2002. That is, until WorldCom announced a massive restatement of earnings after a multibillion-dollar accounting fraud was discovered. The accounting profession took it on the chin once again!

Whereas Enron “cooked the books” using complicated and tricky techniques, WorldCom’s fraud was amazingly simple. Management simply capitalized expenditures that should have been expensed on the income statement. This simple technique added billions of dollars in profits and dramatically altered the true financial condition of the company. Fortunately for the accounting profession, Arthur Andersen was again the “culprit”—or scapegoat—for having failed to uncover this massive fraud.

“PLEASE, DON’T COMPARE US TO ANDERSEN!”

In the aftermath of these high-profile scandals, accounting firms of all sizes rushed to distance themselves from Andersen. The firm that had been highly respected—to the point of near-veneration—just months before was now labeled by its peers as a bunch of “rogue auditors” who had abandoned the values of
the profession. But guess what? Regulators, politicians, and investors didn’t buy the claim that Andersen was an isolated exception.

By the summer of 2002, the capital markets had seemingly lost all faith in the credibility of corporate financial statements. Even though Andersen was no longer a force in the auditing world, stock prices continued to decline. As a result, concerned regulators and politicians expressed their strong determination to restore confidence in financial reporting in the United States.

For example, the Securities and Exchange Commission (SEC) became very aggressive in identifying and prosecuting wrongdoers. Suits were brought and fines levied against both allegedly miscreant companies and their accounting firms. In addition, this federal agency required that senior management at public companies personally certify the numbers on their companies’ financial filings.

In short, the government and business communities no longer trusted auditors to catch material errors. In essence, many people believed that the audit opinion had become worthless.

Most of the criticisms of the accounting profession centered on an issue raised by Arthur Levitt, former chairman of the SEC. In the late 1990s, Levitt sparked a major controversy at the SEC by attempting to ban accounting firms from providing consulting services to audit clients. Though this practice had become widespread throughout the profession, Levitt believed it constituted a conflict of interest that tainted the judgment of auditors.

At a cursory level, his reasoning made sense. If a company paid an accounting firm boatloads of money for consulting services, the auditors might be inclined to look the other way if the company used creative, dubious, or overly aggressive accounting treatments—particularly if the auditors’ co-employees on the consulting side had suggested the tactics in the first place.
Nevertheless, Levitt failed to present tangible evidence to support his contentions. In fact, numerous research studies have concluded that there is no basis to such claims. Furthermore, many smart people reasonably believed that audit quality might suffer if such a ban were implemented. So, for a variety of reasons, and after a heated and contentious debate, Levitt found himself unable to implement the proposed ban.

Fast-forward to 2002: When the public learned that Enron had paid tens of millions of dollars in consulting fees to Andersen, this old issue resurfaced quickly. This time, however, there was to be no debate. Virtually everyone agreed that what was now presumed to be a conflict of interest was a huge problem.

In essence, people apparently believed that auditors were willing to sell their (professional) souls to make a few (consulting) bucks. As one investment manager put it, “All accountants are sheep”; the implication was that auditors would never dare stand up to their clients when disagreements arose, for fear of losing their lucrative consulting engagements.

Of course, this characterization was unfair and untrue. But politicians needed to rant and rave about something—and pin blame on something—and “consulting services” were an easy target. The politicians accomplished this with assistance from the media, which showed little interest in fair and objective reporting.

Unfortunately, yet more bad news arrived on the doorstep of the accounting profession in the spring of 2002. A survey by NFO WorldGroup revealed that clients perceived their auditors to be “incompetent.”

Wow! What’s worse than being called sheep? That’s right, being called incompetent sheep! Not only were auditors accused of lacking integrity, but now their basic competence was being called into question. It seemed that the state of affairs couldn’t get much worse.

Not surprisingly, this environment acted as an engraved invitation for Congress to leap into action. In response to the
A growing list of financial scandals, the nation’s elected representatives in Washington, D.C., enacted sweeping legislation to “fix” many of the accounting profession’s problems. The result was the Sarbanes-Oxley Act of 2002, signed into law by President George W. Bush.

Among other things, this legislation created a new federal agency (the Public Company Accounting Oversight Board) to regulate audits of public companies. And, yes, accounting firms were finally banned from providing a variety of consulting services to audit clients.

FUNDAMENTAL CHANGE IS STILL NEEDED

The Sarbanes-Oxley legislation (and the resulting fallout) created numerous issues for many firms. For example, would the state CPA societies impose similar restrictions on consulting services at nonpublic companies?

At the time this book went to press, many of these matters remained unresolved.

In addition, the Auditing Standards Board proposed and issued new professional standards to help audit firms improve both their methods and their track records for addressing risk and detecting fraud.

Nonetheless, after a tumultuous year in 2002, the dust has largely settled. For the most part, practitioners are returning to business as usual. Another storm has been weathered. But firms that adopt this attitude are making a major mistake!

The events of 2002 should serve as a wake-up call for any accounting firm that conducts independent audits. Folks, it’s crucial to look in the mirror and objectively evaluate the state of your audit practice.

For starters, the rapid demise of Andersen should scare the you-know-what out of any firm that opines on financial statements. This is serious stuff: The public trust is involved! In-
vestors, lenders, managers, and others rely on the statements that auditors certify. If an accounting firm blows it, the consequences can be catastrophic.

“But we don’t audit public companies,” you might respond. That doesn’t matter. Whenever financial statements are issued, an accounting firm assumes risk. That’s why you get paid!

Of course, most firms have always been concerned about quality, and have taken steps to address this issue. In reality, though, these actions fall short. Accounting firms must raise their standards and learn to conduct better-quality audits. In short:

*Fundamental changes must occur in the vast majority of auditing firms.*

What kind of changes? Changes in how audits are conducted. Changes in how engagements are planned. Changes in how evidence is obtained and analyzed. Changes in how professionals are trained.

You see, an overriding problem continues to exist in the accounting profession. The audit approaches used by the vast majority of firms are inadequate and out-of-date. They rely too heavily on detailed procedures (e.g., confirming, vouching, recalculating) that have been used for decades, and many times have evolved into unthinking, mechanical routines.

Not only are these approaches inefficient and costly, they are woefully inadequate for detecting material fraud. Mulford and Comiskey’s book, *The Financial Numbers Game: Detecting Creative Accounting Practices*, describes the many methods companies use, not only to cook the books, but also to fool the auditors. These authors note, for example:

Cover-up activities might take the form of backdating invoices, changing shipping dates, or creating totally false records. The actions taken often are limited only by the imagination of those concocting the scheme.\(^5\)
In other words, even a normally competent practitioner can vouch or confirm every transaction for the entire year and still fail to detect material fraud.

It’s simply too easy for management to hoodwink auditors with phony documents, fake signatures, bogus explanations, and so forth. Auditors have to remember, though, that when a fraud is ultimately uncovered, the public doesn’t care about (or lend any credence to) flimsy defenses like “management didn’t tell us they were cooking the books” or “we’re not trained to catch fraud.”

This serious problem can be corrected only by fundamental changes in the way auditing engagements are conducted. Auditors must adopt approaches and use procedures that offer better odds of detecting material fraud.

Fortunately, the necessary audit approaches and procedures are not a mystery. Our profession doesn’t have to undertake a massive research project to figure out how to improve financial audits. In fact, smart auditors have already been implementing these approaches for years.

Generally accepted auditing standards (GAAS) already encourage application of the approaches and techniques that must become widespread in our profession. In other words, accounting firms don’t have any excuses for further delay—it’s time to modernize your audit approaches right away!

**PURPOSE OF THIS BOOK**

This book addresses several major areas that accounting firms must address to improve independent audits. Specifically, it covers the following topics:

- Risk-based auditing
- Analytical procedures
- Internal controls
Why and How Audits Must Change

◆ Data extraction software
◆ Cultural change

If auditors better understand and properly implement these concepts, quality will improve dramatically.

Does this mean that accounting scandals will never happen again? Of course not. But independent auditors will have much greater success in preventing material frauds from occurring, and will be able to uncover attempted fraud much earlier.

“But,” you might respond, “my firm already addresses most of the items on this list. This isn’t anything new.”

This may be true. But the problem is that most firms fail to go far enough in implementing these concepts. For instance, every accounting firm performs analytical procedures, but those procedures are not as strong or extensive as they should be. As a result, auditors rely too heavily on detailed procedures to gain comfort about the fairness of the financial statements.

Unfortunately, accountants are not quick to acknowledge or accept the need for change. Although these more effective audit approaches have been available for years, most firms have continued to use inferior alternatives, for a variety of reasons that include:

◆ Complacency
◆ Familiarity
◆ Fear of change
◆ Unwillingness to invest in training
◆ Skewed or poorly set priorities

However, these folks can no longer afford to keep their heads in the sand. The scandals of 2002 have changed our profession forever. Auditors simply cannot continue to perform audits using methods and procedures that have only a miniscule chance of detecting material fraud.
As Samuel A. DiPiazza, Jr., and Robert G. Eccles state in their book *Building Public Trust*:

This much is abundantly clear: independent auditing firms must address the questions raised about the quality and relevance of their work. They must do this quickly because the public trust is fragile—easy to lose and hard to regain.6

In short, it’s clear that every accounting firm should seriously evaluate its audit approach and make real improvements. Don’t settle for incremental changes when more dramatic actions are needed. In other words, don’t stick on a bandage when surgery is necessary!

When you begin examining your firm, realize that evaluating an audit approach involves far more than assessing the provider of audit programs. In fact, your current forms and checklists are probably fine. Most manuals allow tremendous flexibility in designing and implementing audit approaches.

The real key to success is to create a culture that encourages intelligent application of the approaches described in this book. This includes establishing and maintaining an environment in which well-trained professionals continuously strive to find more effective ways to fulfill their responsibilities. This, unfortunately, will come into direct conflict with the rote, “same-as-last-year” mentality that exists at so many accounting firms. Chapter 12 addresses this topic at greater length.

While reading this book, you’ll encounter many examples of how to perform better audits. Many are simple, whereas others are more advanced. Rest assured that each one is applicable in virtually every accounting firm practicing today.

Along those same lines, be very careful when you run across a seemingly simple example. It’s tempting to think, “I know that already.” But that isn’t the point, is it? The issue is whether you
(and everyone else in your firm) implement this idea and knowledge consistently in the real world.

Well, it’s time to get started. So I must offer you a warning. Have you seen the hit movie *The Santa Clause*?

In this movie, when Scott Calvin (played by Tim Allen) picks up Santa’s calling card off the ground near his house, he is obligated to become the next Santa, whether he wants to or not. It’s the same deal with this book. Now that you’ve picked up this book, you have an obligation to challenge the practices at your own firm. You don’t have a choice!

Fortunately, like Scott Calvin, you can become a hero by helping your firm take the necessary steps to change.

Have fun reading!

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**NOTES**


RISK-BASED AUDITING: SAVIOR OR VILLAIN?
During the past decade, the popularity of “risk-based auditing” grew significantly as accounting firms across the continent embraced it. This has been a positive, but puzzling, trend. After all, all audits were always supposed to be risk-based: Our standard-setters realized long ago that it’s not cost-effective to examine everything that transpires in a company.

Even if an eager auditor wants to scrutinize every recorded transaction and turn over every stone, the resulting audit still can’t guarantee that the financial statements are fairly stated. Why? Because clients can easily forge supporting documentation, omit transactions from the accounting records, and provide misleading or untrue information to the auditors.

In short, there is no such thing as a foolproof or perfect audit. No matter how much evidence is obtained, more tests can always be performed to make the audit stronger.

Of course, at some point the cost of gathering additional evidence exceeds the benefits (that is, the principle of diminishing returns kicks in). Therefore, auditors need guidelines to decide when enough is enough.

This is why our profession developed the concept of reasonable assurance. This principle basically requires that auditors perform enough work to obtain reasonable assurance that the financial statements are free of material misstatements.

Critics sometimes argue that “reasonable” (as opposed to