

DO BUSINESSES FAIL DUE TO BAD MANAGEMENT OR BECAUSE OF POOR AUDITING?

Auditors' primary responsibility is to provide assurance about the reliability and relevance of an entity's financial information and internal controls. In an environment characterised by rapid change, global competition and improved information technology, measures of an entity's current state and recent past are relatively less important than measures of what are likely to happen in the near and distant future.

Today, Accountants and Auditors are increasingly called upon to measure and report on threats to a business entity. The last decade mandated external financial reporting to reflect the new "rapid change" environment through expanded requirements for disclosure of risk assessments by management, through discussion and analysis in financial statements, and through increased disclosure of the sensitivity of accounting estimates to possible changes in assumptions. At the process level, several countries now require management or directors assertions that they have adequate internal control, including risk control processes. One way to characterise a business entity and the risks it faces is in terms of its stated long-term goals, the strategy that management has chosen to achieve these goals, and the business model and operating plans for guiding actions to implement these strategies over a shorter period. These threats affect interpretation of accounting information, financial performance and other industry conditions. These threats can be measured and classified in various ways and can occur throughout the chain of events. For instance, in the U.S, public accountants and auditors have experience in the reporting of risk assessments through the American system of accounting disclosures, securities regulations, and corporate governance. In the UK, External auditors therefore have some experience attending to management assertions about compliance with FRS's criteria for internal controls

From the above discussions, it has to be recognised that directors and management determine the objectives of the entity, its strategies to achieve objectives, and a business model detailing how business processes will interrelate as well as operating plans to implement strategies in the short-run, medium and long run periods. Management must decide how to deal with the risk and reward in a strategy and its implementation. Attitudes toward risk will affect which business activities the enterprise undertakes, and it will implement strategies only if it can limit risk inherent in a strategy to an acceptable level. Auditors' only visit the business premises briefly during the business accounting period to express an opinion on whether or not the financial statements prepared by the management meet the generally accepted accounting rules, standards' and regulations.

Given the understanding of an entity's objectives, strategy, plans and along with consideration of current external and internal conditions, Auditors need to identify and report to management all of the important weaknesses in their management letters that could adversely affect the achievement of the entity's objectives. This critical step requires knowledge of the entity as well as business in general and the likely future environment on how the auditors can link knowledge of various activities of the firms. Management consequently, after presentation of the report might reserve the right to bring the auditors finding on board or may decide to ignore them.

At the heart of every organisation's activities to succeed must be straight and tighter daily execution of internal controls. Control activities are the policies and procedures designed by management to provide reasonable assurance that the business responses are implemented. These must be applied throughout the organisation and should include approvals, authorisations, cancellations, confirmations, observations, verifications, reconciliations, reviews of operating performance, physical security of assets, and segregation of duties. So, upon assuming duty as the company auditors, they should be familiar with control activities for financial reporting, and extends the concept to responding to all risks during the course of the audit programme. From this, it can be argued that companies need independent auditors' to evaluate the business financial activities because these experts have enormous competencies, skills, and experiences in reporting to shareholders.

Research has shown that it is difficult to get consensus on what makes a good company since there are so many dimensions on which you can measure excellence. There are many who measure excellence in terms of financial results; good companies earn high returns on their investments and reinvest their funds wisely. There are some who believe that good companies have managers who listen and respond to their stockholders' best interests and that corporate governance is the key. Finally, there are still others who believe that good companies respond not just to stockholders but also to other stakeholders including their customers, employees and society. Thus, you can have companies that make it on one list and not another. For instance, General Electronics (GE) in the US delivered superb financial results under Jack Welch but corporate governance was weak at the time. Conversely, Ben and Jerry's company was ranked highly for social responsibility in the 1990s but faced financial disaster during the same period. Can we say this was caused by the company's auditors? Indeed, the simplest and most direct measure of how good a company is and how well it is run by its' management is the firm's financial performance. A well run company should raise capital as cheaply as it can, invest it well and find worthwhile investments for the capital. In the process, it should enrich investors in the company. A company that refuses to look into the future with strategies from its management may fail to succeed and when this happens, the auditors of the company cannot be blamed much as they are not part of the decision making body of the organisation.

Further research shows that some companies fail because its management treats auditors and other independent reviewers with open contempt. They do not want anyone to review and criticise their activities nor the activities of their "trusted" employees. They operate under the illusion that their actions are beyond reproach and not subject to audit. Some business owners prefer to have "other people" audited or investigated so that they can get the ammunition to eliminate certain people and show that certain conducts cannot be tolerated. The philosophy of "trust but verify" is therefore foreign to them. In situations like this, auditors advice to management on how the business is being run or should be run might fall on deaf ears as they are only interested in the payment of their fees.

Nonetheless, many have argued in the past and present that poor auditing has caused many companies to fail because there are decided cases in the past that testify that auditors failed to raise alarm to the financial statements that they have audited. In this view, researchers must realise that bad management practices are detrimental to organisational effectiveness. Their risk-based reviews should assist their organisations in identifying and eliminating such practices. This entails performing assurance and consulting engagements with independence and objectivity. Job security therefore, should be made secondary to compliance with the audit standards and professional code of ethics. Given any hostile environment that auditors operate in, they should be prepared to resign from their positions if it is the only option to make their audit observations known to the internal and external stakeholders. Similarly, auditors should not let contracts or monetary issues cloud their independence and professional judgment. They should know that weak internal controls contributed to by pervasive management practice can generate fraudulent financial statements and opportunities for other types of occupational frauds. In addition, auditors should avoid credibility problems by not engaging in bad management practices or appearing to turn a blind eye to such practices during internal control reviews. Thus, self-assessment is a critical step toward objective reviews and effective fight against poorly managed business because; lack of credibility has been known to hamper quality audit work as was identified in the Enron and WorldCom case which reveals that internal and external auditors can pay heavy prices if they know but fail to act on red flags in auditable areas.

According to many financial analysts around the world, for the better part of the past two and a half years, corporate accountants have been making huge write-downs, reducing the book value of assets. Accounting has actually been a bellwether in the sense that it drew attention to the securities that were held by financial institutions. It was the recording of write-downs of these assets that really started to draw attention to the fact that a lot of these financial institutions had themselves become ‘toxic’ assets.” Because they had to record those holdings at “fair market value,” auditors were forced to figure out and report the current worth of those securities. But the amount of that estimation turned out to be, in many cases, “close to zero.” So bad news for companies’ assets was, but good news for accountants in terms of moneys received from the companies’ management as tips. Unlike the infamous Enron and WorldCom collapses as mentioned above, the financial crisis cannot be pinned on poor accounting. In fact, research shows accountants and auditors are crucial to providing the sort of credible information markets need to prevent financial meltdowns.

It is an undisputed fact that reliable accounting and auditing is a key element to business survival. In another recent study, this one published in the Journal of Accounting Research by Profs. Inder Khurana and Raynolde Pereira, they pointed out that “accountants and auditors contribute to helping money get to the places where it can earn the highest return. This then translates to higher economic growth rates.” There is some pretty compelling evidence that accounting and auditing have what we like to call a ‘first-order effect,’ meaning that the actual quality of accounting and auditing can play a major role in directing where money goes in an economy to get it to the best sources in terms of economic growth. Mark DeFond, and Joseph A. DeBell, Professor of Business Administration at the University of Southern California, says auditing work provides a unique insight into how capital markets develop so business set-ups must be prepared to take good advice from such independent consultants such as the company auditors.

In conclusion, the framework for effective management practices discussed in this article is one that can help organisations in building an environment conducive for a highly motivated workforce, transparent accountability, ethical decision-making, shared governance process, proactive problem-solving, cost efficiencies and satisfied customers. These will, in turn, contribute to a vibrant corporate culture that helps in building and sustaining a healthy bottom line approach for organisations to either succeed or fail. My own research suggests the real drivers of accounting and auditing quality is not the standards per se, but the rigor of enforcement through high-quality audits. I can confirm that incentives of companies and their auditors are critical, and this is the role played by regulatory agencies, as well as having a strong legal system in which investors can sue companies and their auditors when corporate accounting reports are misleading and the enforcement by auditors has been negligent.

For most non-financial assets in the US for instance, market values are estimated and thus are highly subjective. Subjective values, in turn, give companies enormous room to fudge numbers. When this happens, it makes the information to be audited virtually impossible. In fact this was a leading problem with Enron's financial statements. This could spell real trouble, especially in a world economy still struggling to emerge from perhaps the worst fiscal crisis since the Great Depression of the 1930s. Any time there are corporate failures; people ask the question, 'Was it an accounting failure? It often comes as a surprise when a company fails, and people wonder, 'Why didn't we know about this? Was this because management was reporting too optimistically the results in the past and the auditors were letting them get away with it?' Those issues always arise because accounting and auditing are not an exact science; they rely on subjective estimations that cannot be verified with certainty. For this reason auditing is crucial in giving credibility to the numbers that companies report. So, misleading reported financial statements can cause the collapse of the company in future if the figures provided by management suffer window dressing before they are submitted for audit.

Felix Hanson, FCCEA (December 28th 2009)