ETHICS IN EXTERNAL AUDIT – LESSONS LEARNED FROM CURRENT AND PAST PROBLEMS

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A search for "Enron Code of Ethics" on Wikipedia reveals a short entry suggesting that copies of the code, subsequent to the bankruptcy of Enron in 2001, were being sold on Ebay, for over $200 in at least one case. The interest in the code appears to be its comedic value – the idea that a company which behaved so egregiously could even have a code of ethics seemed laughable. Many books and articles on Enron that have since been published are consistent in highlighting a weak culture of ethics as being one of the root causes of the collapse, which of course was also terminal for their auditors.

These issues have not gone away. High-profile corporate failures and scandals in the last few years have placed the audit profession under intense scrutiny. One of the consequences is an increased expectation that auditors should identify – and report on – ethical concerns as part of their work.

UK Retailer – ethics, governance and the effect on auditors

A major UK-listed retailer was publicly described in 2007 as "the least ethical big company in the country." In 2016, it was the subject of a UK Parliamentary report which highlighted numerous problems connected with employment practices at the company's premises, leading to widespread attacks in the media on its ethics culture. The report specifically linked the issues to corporate governance, with statements such as "Corporate governance… goes to the heart of the issues that have been raised in our inquiry".

At the date of writing, this company has no external auditor. The one auditor they used since listing in 2007 resigned in August 2019 after management reportedly failed to inform them of a substantial tax demand until the day of issuance of the financial statements. Attempts to appoint new auditors have so far failed, with at least 6 firms already having been approached. The head of audit for one major firm told the Financial Times that "This is not an audit issue, it is a corporate governance issue."

The Deputy Executive Chairman, founder of, and majority shareholder in, the company was requested by the Parliamentary committee to address the issue of corporate governance. When specifically asked how he was going to improve corporate governance, the Deputy Executive Chairman said, "I can only do my best and my best may not be good enough, as you say, but my best is all you can have". This demonstration of failure to properly commit to governance improvements is consistent with much of the criticism he has publicly faced in the UK press.

Whether poor corporate governance gives rise to poor ethical culture, or the two weaknesses contribute to each other, is not necessarily a question that needs to be answered. Instead, we need only accept that a link exists between the two. The response of auditors to identified weaknesses in either corporate governance or ethical values of an auditee would be to consider the implications across all areas impacted by both.

The changing face of external audit

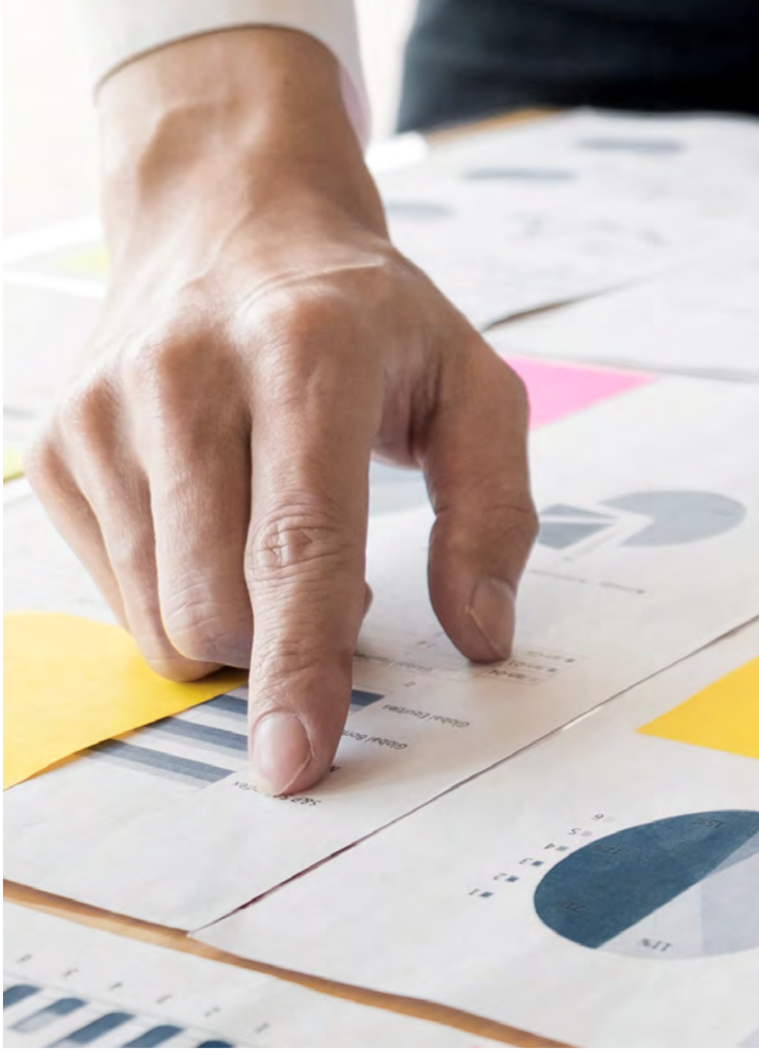
External auditors have long been required by virtually all standard-setters to consider a wide range of features of an auditee as part of their planning for an audit. International Standard on Auditing 315, for example, requires that auditors assess whether management and those charged with governance have maintained a 'culture of honesty and ethical behaviour'. An auditor's conclusion on this would then contribute to other assessments, such as the quality of the overall internal control environment or the risk of management override in financial reporting. How the auditors adjusted their audit strategy to compensate for the widely known issues around ethics at the company described above is unclear, but one would assume that, for example, professional skepticism would have been applied with more rigour to any representations made by management.

In recent years international standards have in addition begun to require the publication by auditors of Key Audit Matters (KAMs) for their listed clients. In the US, a similar requirement will mandate disclosure of Critical Audit Matters (CAMs) from 2019 onwards. Prior to this, audit reports were generally 'boilerplate', with additional narrative added by the auditors only in the (relatively rare) situations that they either gave a modified audit opinion or included an 'emphasis of matter' drawing attention to a feature of the financial statements. No information was given by auditors of the areas they considered to be highest risk.

KAMs and CAMs are aimed at protecting the public interest by drawing users' attention to the issues which were of significant focus for the auditors.

KAMs have been mandatory for public companies in most of the Middle East, where International Standards are applicable, for several years now. So what types of issues are they focusing on?

Of the audits of the top 20 largest publicly listed companies in the world today, only 8 currently fall under the remit of KAMs – those subject to International Standards on Auditing or Hong Kong Auditing Standards. Most of the other 12 are subject to US standards and will begin publishing the equivalent CAMs for audits of 2019 financial statements.



Key audit matters and ethics – what do we see from large audits?

The number of KAMs in these 8 large company audit reports ranges from 2 to 6, with an average of 3.65. Whilst "ethics" or "ethical" appears (usually 3 times) in all of the audit reports, it is always within the 'boilerplate' sections referring to matters such as the auditor's responsibility. In the more meaningful freely drafted KAMs section, the word "ethics" or "ethical" does not appear once.

So how can the profession claim to be paying proper attention to ethics and ethical culture if it is not reporting ethics as an area of focus to stakeholders?

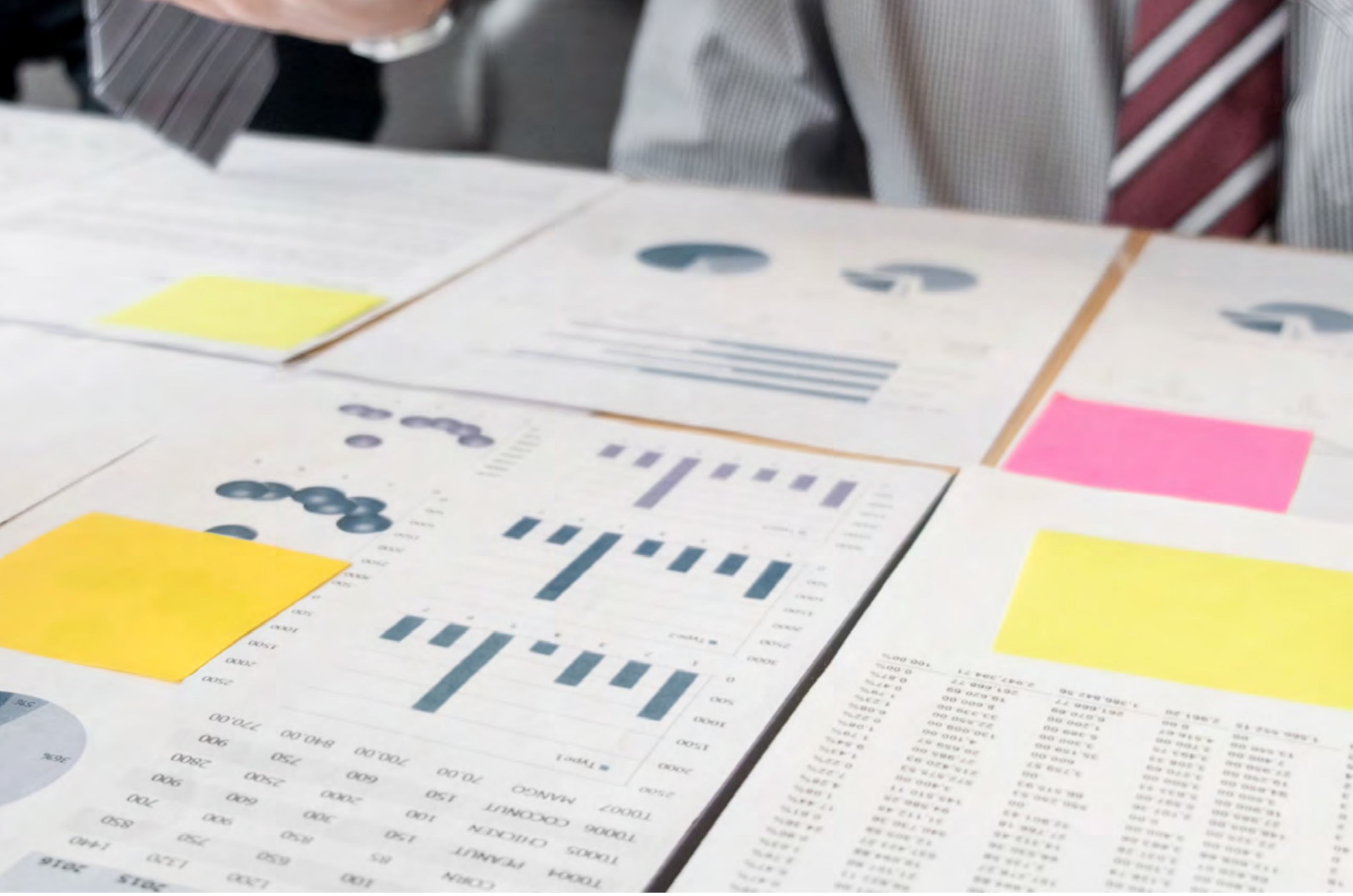
Predominantly, it is down to the nature and purpose of KAMs. They are not intended to be a means by which the auditor describes all steps they have gone through in their audit, they are intended to identify the areas of audit risk that set this particular audit aside from most others, and as such tend to be relatively specific. Every large audit in today's world could be expected to have a significant focus on testing of the IT systems, but stating this as a KAM would not provide meaningful information to stakeholders. In the same way, every audit will include consideration of numerous ethical factors.

Also, significant ethical issues are considered by auditors in their ongoing deliberations around accepting the client and continuing to act for them. Any ethical issues of sufficient significance to require reporting as a KAM may arguably require that the audit relationship is discontinued, as is the case with the UK company referred to above.

Finally, a majority of the matters raised as KAMs are anyway significantly impacted by ethical culture, because they relate to accounting estimates. Accounting estimates are a common feature of financial statements, especially those prepared under the more principles-based international standards compared to the more rules-based US standards.

Accounting estimates

For auditors, accounting estimates present a problem; it is not possible to simply recalculate a number and be comfortable. Instead, the qualitative inputs to the estimate need to be considered. Understanding the risks that management may manipulate these inputs in order to achieve their own objectives is one reason for the auditor's assessment of the ethical values of the auditee.



In a company which has demonstrated strong ethical values and has a decent corporate governance framework, an auditor could expect that management decisions in respect of accounting estimates would generally be subject to appropriate review and be challenged, whether by more senior management or by a board committee. Of course, this does not mean that an auditor can drop their professional skepticism and blindly accept what management are telling them. But knowing that the CEO is being rewarded for more than just the bottom line, which we would expect to be the case in a well-governed company, gives an auditor some degree of comfort that accounting estimates are likely to be aiming for the correct, not the most beneficial, number. The risk of collusion between senior management or even the board is significantly reduced and the auditor can potentially shift the focus of their efforts onto other areas which might present a higher risk, such as new or changing accounting standards.

Ethics, governance and audit risk – a no-brainer?

Looking back, auditors of failed companies with a demonstrable history of weakness in ethical culture and values must have serious regrets. Enron is the most publicized and amongst the more obvious examples to look at, but there are many, many, more. Every such business failure costs the audit profession massively in terms of public trust, even when a high-quality audit has been performed. There is a financial cost to the audit firm's stakeholders, and potential consequences have historically even included audit firm collapse.

The new era of KAMs and CAMs definitely contributes to the information auditors provide to stakeholders and improves their decision-making ability. Regardless of whether auditors are reporting ethics as key or critical audit matters, it is a no-brainer for them to maintain a razor-sharp focus on ethics throughout both the audit process and in the choosing of which clients to work with. ■