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Corporate Failures and the
Challenges Facing the Audit Profession

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Corporate Failures and the Challenges Facing the Audit Profession

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**THE UNIVERSITY OF AUCKLAND
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FOUNDATION FOR
**AUDITING
RESEARCH**

Where Are We Now?

The profession is at a critical juncture. New and complex business arrangements and financial transactions have ... increased the risks of audits. Information technology has changed the nature and complexity of a company's records ... Business failures generate wide media attention, litigation ..., and [regulatory] scrutiny ... resulting in widespread skepticism of the objectivity of the profession ..."

*[Report to the Public Oversight Board of the SEC
Practice Section of the AICPA, 1994]*

My General Perspective

- Auditing is a highly respected profession which is grounded on its valuable contribution to a greater good (“a calling”) using professional judgement that benefits society.
- Auditing is of most value in settings where trust matters most:
 - Financial information
 - Non-financial information
 - Conduct of processes and behaviors
 - Fiduciary and custodial relationships
 - Third party platforms and services
- Developing trust systems is critical, and demands for trust are expanding.
- Professionalism and judgment is the heart of developing trust in systems that operates within a complex financial reporting ecosystem [Dowling, Knechel and Moroney 2018; Knechel, Thomas and Driskill, 2019]

Scandal, Investigation, Reform, Repeat (?)

- **Something goes wrong (e.g., Enron)**
- People complain (Media, Politicians, Regulators): “Where were the auditors?”
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- **Something goes wrong** ... because it always does.
- And we play the game again (S&L crisis, dot.com bubble, Asian currency crisis, Enron/Worldcom/Parmalat/Ahold, GFC/Lehman Bros ... Carillion/Wirecard, Americanas, FTX/SVB)

A critical but rarely asked question:
What are the opportunity costs and dead weight loss of regulation aimed at the “last” scandal on market participants who are not responsible for that scandal?

The Audit “Process”

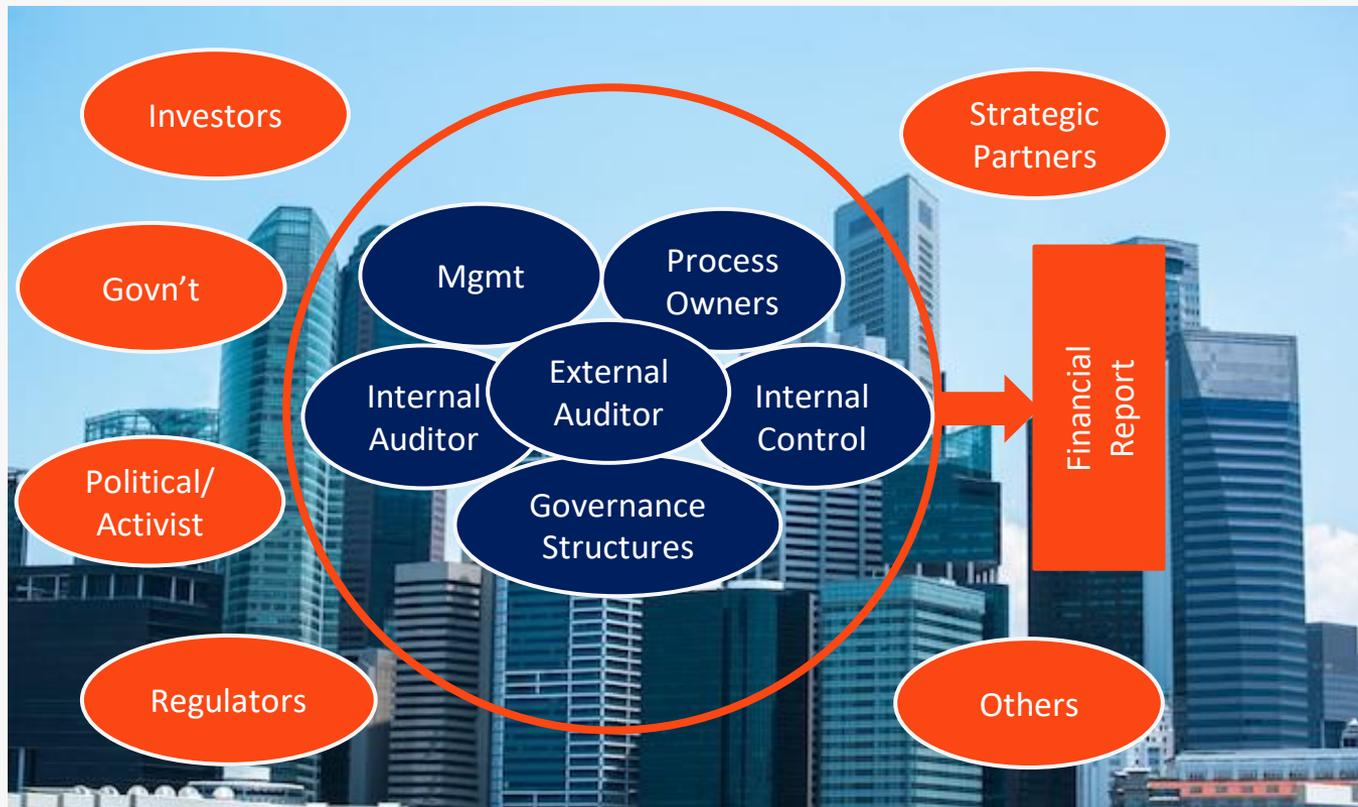
- An audit is an idiosyncratic service with an unobservable outcome conducted by experts exercising professional judgment in an uncertain environment subject to regulatory pressures.
- The Audit changes *over time*:
 - Prior to 1930: Not required to observe inventory.
 - 1970s: Auditors routinely performed IA-type tests.
 - 1980s: Increased use of indirect tests (e.g., analytical procedures).
 - 1980s: Deregulation led to expansion of non-audit services.
 - 1990s: Service blending → Enterprise and strategic risk assessment.
 - 2002: The Integrated Audit
 - 2004 and beyond: Regular regulatory intervention.
 - Now: Technology, technology and technology

The Audit “Process”

- The Audit changes *across clients*:
 - Tradeoffs of procedures (Planning vs. testing)
 - Outsourcing/insourcing assurance
 - Across-service “bundling”: NAS
 - Role and quality of other stakeholders
- The Audit changes *across auditors*:
 - Specialists (knowledge differences)
 - Offices (contagion effects)
 - Partners (“style”, incentives, rotation)
 - Teams (limited evidence)
- The audit requires cooperation *across* a complex network of participants with competing incentives.

The “Old” Financial Reporting Ecosystem

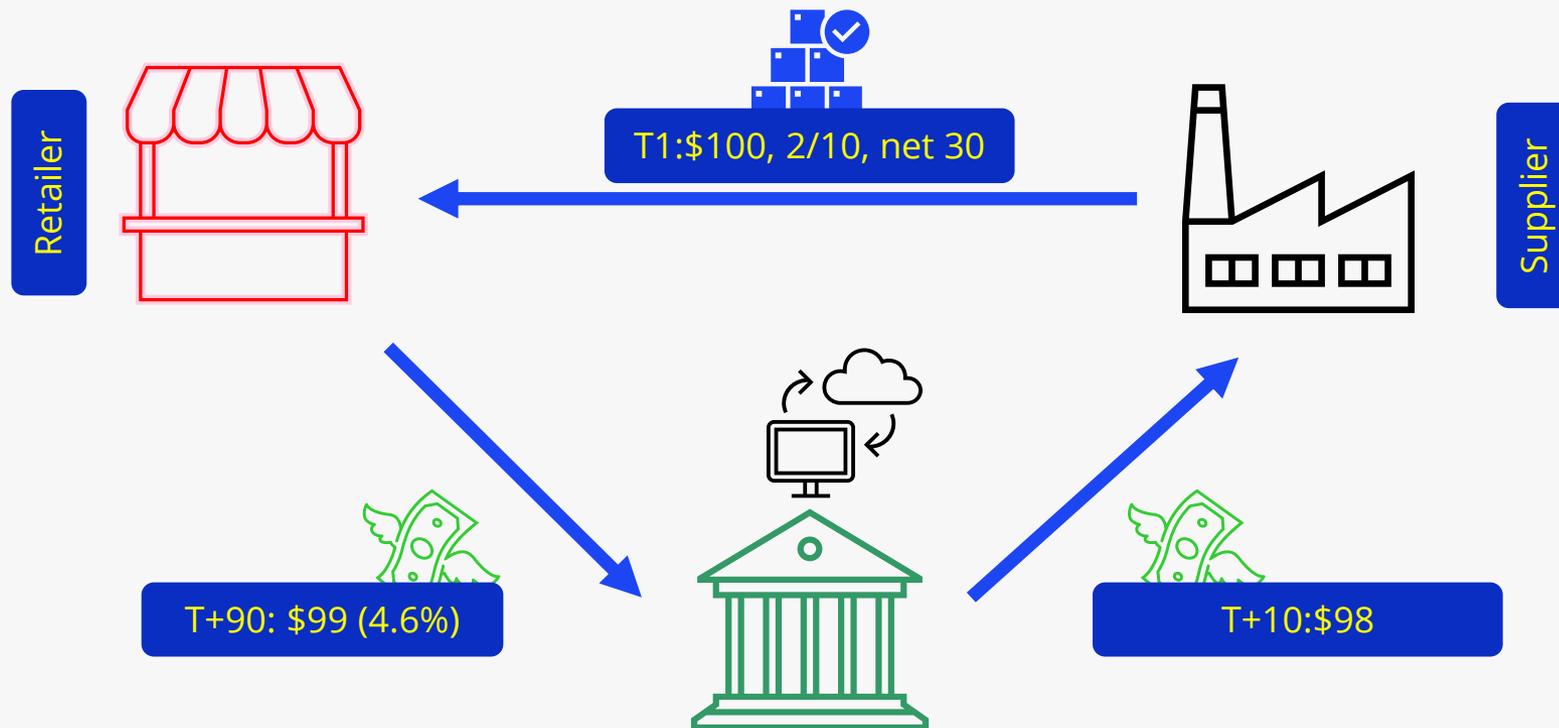
Economic Ecosystem:
“a network of businesses and individuals considered to resemble an ecological ecosystem because of its complex interdependent parts.”



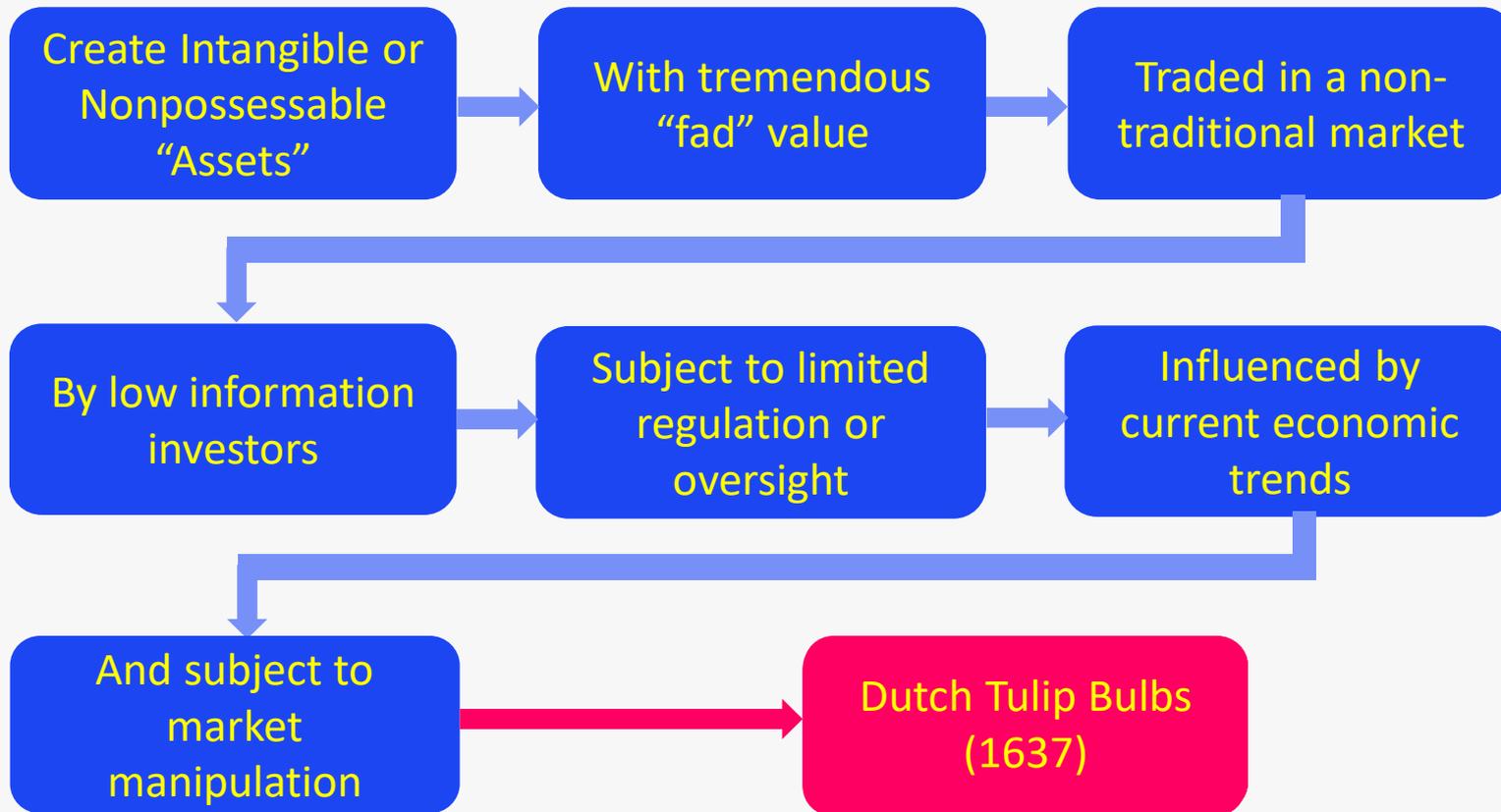
A “Global” Financial Reporting Ecosystem



A Case Study: Americanas



Another Case Study: Who Am I?



Rethinking Some “Old” Questions

- **What is an auditor?** Are accounting programs the best/only entry path?
- **Audit Demand:** What are the value drivers of auditing?
- **Independence:** Is it possible with so many cooperative relationships in the financial reporting ecosystem?
- **Auditor Tenure:** How important is client-specific knowledge?
- **NAS:** How important is a multi-disciplinary skillset in an audit firm?
- **Audit Report:** Does it adequately and effectively communicate the level of assurance?
- **Expectation Gap:** Can it be reduced within the financial reporting ecosystem?
- **Audit Standards:** Does standardization fit an idiosyncratic audit process?
- **Innovation:** Who should drive modernization/evolution of audit practices?
- **Regulation:** Does escalating regulation result in unintended consequences that may limit audit quality?

Some Final Observations

- The challenges are not new, but the environment of auditing and the technology of auditing, has certainly evolved and expanded.
- Does the auditing profession have some unique advantages in the area of ESG and sustainability?
 - Established processes for verification (risk, control, evidence, materiality) 😊
 - Subject matter expertise (measurement, aggregation, disclosure) 😞
 - Quality control infrastructure (oversight and review) 😞
 - An established independence framework 😊
- A renaissance in “stewardship”?
- More disruptive options?

Where to Now?

*For every problem there is a solution which is simple, clean
... and wrong."*

(H.L. Mencken 1880-1956)

Where to Now?

“We want to measure our contribution more by the quality of the service rendered than by whether we are making a good living out of it ... It has been the view of accountants up to this time that their responsibility begins and ends with the certification of the balance sheet and statement of earnings.

I maintain that the responsibility of the public accountant begins, rather than ends, at this point.”

Arthur Andersen, 1913

[Upon the Founding of Arthur Andersen and Company]