Why and How Audits Must Change

PRACTICAL GUIDANCE TO IMPROVE YOUR AUDITS

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John Wiley & Sons, Inc.
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

Thomas P. Houck is the founder and Chairman of AuditWatch, Inc. He is a nationally recognized authority on auditing and has been named to Accounting Today's List of 100 Most Influential Persons in the profession for the past four years.

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.
## Contents

*Preface*  
vi

1. **A WAKE-UP CALL FOR ALL AUDITORS**  
   “Please, Don’t Compare Us to Andersen!”  
   Fundamental Change Is Still Needed  
   Purpose of This Book  
   1

2. **RISK-BASED AUDITING: SAVIOR OR VILLAIN?**  
   Why Many Firms Resist Risk-Based Auditing  
   Progress Must Be Made  
   13

3. **THE RISK OF “COOKING THE BOOKS”**  
   General Methods of Cooking the Books  
   Why Companies Cook the Books  
   How Auditors Should Assess the Risk that a Client Has Cooked the Books  
   Tailoring Audit Programs  
   21

4. **OTHER RISKS AND CONSIDERATIONS**  
   Ask “Anticipation” Questions  
   Perform Proactive Research about the Client’s Business  
   Perform a Diligent Preliminary Analytical Review  
   Risk Assessments During Fieldwork  
   53

5. **THE MANY BENEFITS OF ANALYTICAL PROCEDURES**  
   Quality  
   Efficiency  
   Client Service  
   Staff Morale  
   67

6. **COMMON PITFALLS OF ANALYTICAL PROCEDURES**  
   Uncorroborated Client Explanations  
   81
Contents

Imprecise Explanations 89
Lack of Informed Expectations 93
Setting Scopes for Variance Analyses 101

7. AN EASY APPROACH TO IMPLEMENTING ANALYTICAL PROCEDURES 103
   Step One: Think Analytical First 105
   Step Two: Determine the Proper Strength 119
   Step Three: Test and Evaluate Results 123
   Lousy Internal Controls 129
   Closing Thoughts 132

8. INTERNAL CONTROL: THE MISUNDERSTOOD CHILD 135
   Types of Controls 139
   Minimum Audit Requirements 146

9. TO TEST OR NOT TO TEST 155
   A Four-Step Approach to Testing Controls 159
   Step One: Evaluate Cost-Benefits 159
   Step Two: Identify Specific Controls to Test 164
   Step Three: Select and Perform Control Tests 169
   Step Four: Arrive at Conclusions 173
   Conclusion 175

10. TALKIN’ TO THE CLIENT 177
    Who Should Ask the Questions? 180
    How Reliable Is the Evidence Source? 181
    Do You Hear What I Hear? 182

11. DATA EXTRACTION SOFTWARE 187
    Purpose of This Chapter 190
    Benefits of Data Extraction Software 191
    Case Study 196
    How to Proceed 199

12. ACTION STEPS 207
    Thinkers and Robots 209
    Three Essential Steps for Transforming Your Firm 211
    Closing Thoughts 227

Index 229
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.
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.