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Challenges of Auditors and Audit Reporting in a Corrupt Environment

Prince Kennedy Modugu* Nosa Ohonba and Professor Famous Izedonmi
Department of Accounting, Faculty of Management Sciences, University of Benin, PMB 1154, Benin City, Nigeria
*Email of corresponding author: princekenny2010@yahoo.com

ABSTRACT

The rising spate of corruption in both private and public establishments has assumed an enormous dimension. This development has eroded public trust in financial statements. Auditors in their duty to expressing professional opinion on the truth and fairness of financials are ostensibly bedeviled with quantum of challenges which could result in the issuance of a clean bill of health to corruption-riddled establishments. It is against this background that this paper critically examines the challenges corruption poses to auditors and audit reporting, and proffers formidable cures to ameliorate the achilles heels and to redeem the auditing profession from impeding collapse.

Keywords: auditors, corruption, audit reporting

1. INTRODUCTION

Historically, auditing was confined principally to public accounts. This is a clear indication that from an early date, it was customary for an audit of the accounts of manors and estates to be performed. The person whose duty it was to make such an examination of accounts became known as the auditor, the word being derived from the Latin ‘audire’, meaning “to hear”. Originally, the accounting parties were required to appear before the auditor who had their accounts. The audit of business accounts did not become common until the nineteenth century. The enormous increase in trade in that period, which was fostered by the discovery of steam power and by mechanical inventions, generally led to the formation of numerous joint stock companies, and other corporate undertakings, involving the use of large sums of capital under the management of a few individuals (Akpomi & Amesi, 2009). Under these conditions, the advantages to be obtained from utilizing the services of auditors became apparent to the public generally, and a great increase in the practice of auditing resulted; as the present day forms the most important part of a professional accountant’s practice (Walter, 1969).

With complexities in both public and private sectors, the duties of auditors became heightened. These complexities were met with corruption, a major feature of developing economies thereby threatening the independence, integrity and objectivity of the auditors. As a result of the increase in the level of business activities, both in the public and private sectors, it is now required by statute that activities of governmental and corporate business organizations be audited. The implication of this requirement is to ensure that those entrusted with funds are held accountable. Auditing therefore ensures that accounts and records of organization show a true and fair view. Auditors do this by thorough examination of the books of accounts of businesses and to confirm whether there is appropriate approval and authorization for every transaction.

If auditors are not competent especially in bringing their skills to bear in a corrupt environment, then the whole audit process is of no value. In Nigeria, as well as the developed countries, Chartered Accountants in practice (Auditors) are seen as competent but a number of recent events including corruption and failures of some banks and some companies have given rise to doubts in the minds of the business community (private and public sectors). An interesting idea put forward by Abadi (2005), is that competence is constantly being improved but at the same time economics has dictated that the time spent on auditing is constantly being reduced even though modern laws, in accounting systems and structure are steadily becoming more complex.

It is against this backdrop that this study is undertaken to find out the challenges of the auditors in a corrupt environment and by extension identify the factors for such challenges.

2. NATURE OF AUDITING PROFESSION

Akpomi and Amesi(2009) posit that in the early days of auditing, the prime qualification for the position of an auditor was reputation. A man known for his integrity and independence of mind would be sought for this honored position, the matter of technical ability being entirely secondary. Besides, audit function in those days, was never confused with that of an accountant. However, as accountancy gradually became more complex and concerned with technicalities, auditors found themselves out of their depth and, in turn, became increasingly dependent upon the expertise provided by the accountants until, eventually, the audit function itself became totally dominated by the accountancy profession.

Millichamp (1990) cited in Akpomi etal (2009) asserts that a vital part of auditing is that the auditor must be independent of the management whose accounts he is auditing. In the case of companies, he must not be connected with either the directors or the shareholders. He (the auditor) must also be independent of government agencies or other groups who have contact with the business. For these reasons auditors form themselves into independent firms willing to perform audit for a fee for whoever is able and willing to employ them.

Howard (1982), in his view opines that for auditors to be independent they should not invest either physically or otherwise in the organization he/she is auditing. According to Howard, if an auditor has interest of any kind in the organization he is auditing, there will be no independence of any kind and the Stakeholders or Members of the Board of Directors have to dictate to the auditors what they will do, thereby losing the pride of independence in an auditor.

Abadi (2005) reiterates that for any auditor to be independent of himself, he should be disinterested in anything (financial or otherwise) of the organization he/she is auditing. When this happens it means the auditor has the right to actually carry out investigations as it is required of him in the profession. This is in line with the view of Millichamp (1990), who opines that, an auditor's approach to work in a spirit of independence of mind by "not making loans to its clients nor receiving loans from clients. A similar prohibition is on the guarantee of individuals' partners; their spouses and their minor children should also not make loans or guarantee loans to clients nor receive loans or guarantee from clients. It is pertinent to say that for auditors to act independently, they should avoid professional relationships where personal relationship also exists.

Problems can arise with work required by family or by personal friends. Problems can also arise where an auditor has been engaged in the same audit for many years or has a business relationship with a client. But in Nigerian context the case of auditors differs because they stick to find relations, friends and well wishers when called upon to audit a firm or organization.

3. AUDIT PLANNING PROCESS IN A CORRUPT ENVIRONMENT

Khan(2006) states that as a starting point for corruption auditing, the auditors should hold on to the traditional assumptions about the behaviour of the staff with respect to organization's business and should not commence audit planning with the suspicion of corruption. However, at the stage of familiarization of the organization and its operations, they should remain alert to the possibility of corruption. Therefore, they should proceed cautiously. In the process of normal audit planning, they should try to determine the possibility of corruption through review of various regulations, rules and procedures. Besides, in the process of interviews of key personnel, they should identify any opportunities for corruption. The audit plan can state the audit objective of corruption audit, besides other audit objectives, as follows:

One of the objectives of this audit is to assess the possibility of corruption in …
(name the function or operation under audit) of the … (name) the organization and to
evaluate the efficacy of the existing control environment in preventing it (Khan,2006)

According to Khan(2006), the corruption audit planning process would also pass through the familiar audit planning stages. However, it will have some specific features as discussed below. The full range plan for corruption audit should involve the following steps:

(a) Knowing the Audit Entity
(b) Developing the Audit Criteria
(c) Building Inventory of Corruption Opportunities
(d) Applying Corruption Opportunity Test (COT)
(e) Writing the Audit Plan

Knowing the Audit Entity

The familiarization process will start with a detailed review of applicable laws, regulations, rules and operational standards with a view to understanding the audit entity and its operations. It would enable the auditors to understand the mandate, mission, objectives and main operations of the organization. It will also inform the auditors about the organization's structure, staffing, locations, clientele and operational plans. While doing so, the auditors will remain alert to the identification of possible opportunities for corruption.

Developing the Audit Criteria

The audit criteria for corruption audit should be developed in the light of good management practices accepted in the field of operation under audit. The auditors should familiarize themselves with the lead practices in the field through study of various manuals and background literature on the subject.

Applying Corruption Opportunity Test

Once the auditors have an inventory of corruption opportunities, they should proceed to prepare a short-list of these opportunities in the environment of the organization under audit. This can be done by applying Corruption Opportunity Test (COT). They should try to figure out the status of the organization or its various operations with respect to opportunities for corruption.

The objective of the Corruption Opportunity Test is to determine if the actual circumstances prevailing in an organization are conducive to corruption and if so, to what extent. It is possible that the systems and procedures of the organization are not robust, yet the culture of the organization or the overall environment of the country act as a deterrent and people still do not indulge in corruption at a significant scale. It could be vice versa as well. The systems and procedures of the organization may be quite robust, yet the actual practice may provide opportunities for corruption due to environmental reasons or due to laxity of the top management or due to non-implementation of the rules against corruption. Thus Inventory of Corruption Opportunities is a theoretical possibility. By applying Corruption Opportunity Test, the auditors go a step further to assess the likelihood that the opportunities for corruption are actually being availed by corrupt people in the organization. If they assess that the opportunities for corruption exist and the probability of their existence is high, then they should plan an extensive examination of organization's operations. During field work, in such a situation, the auditors should select larger samples of various transactions from the high corruption-risk areas to confirm their assessment emerging from the application of COT.

Writing the Plan

The last step of the planning phase and first task that the auditor has to perform at the execution stage is to write an audit program tailored to the objectives of the corruption audit. He should follow the standard procedure for developing an audit program. For the purpose of focusing on possibilities of corruption they would embed the audit program with two types of issues:

General issues relating to common functions in most of the organization

Specific issues relating to the specialized operations of the organization

General Issues

For focusing audit on detecting opportunities of corruption, the auditors should build into the audit program following general issues:

- Transparency
- Good Governance
- Economy
- Efficiency
- Effectiveness

The general issues would pertain to such common functions as general administration, procurement and human resource management of the organization or department being audited.

Specific Issues

The specific issues would relate to the technical or specialized operations of the department or agency being audited. For example, these issues would relate to review of specific laws and rules relating to the technical work of the department such as Income Tax Law, or Customs Law and rules and procedures framed subordinate to these laws.

4. CHALLENGES OF AUDITING IN A CORRUPT ENVIRONMENT

Corruption inhibits the quality of audit service and weakens the institutions of good corporate governance. Corruption is a cancer which attacks the structure of the public and private sectors. Corrupt practices are intentional acts committed with a view to giving, accepting and soliciting an advantage inconsistent with official duty and the rights of others or the abuse of public power for private gain. Corruption is acceptance of bribe by a person who demands or accepts some form of gain to perform or fail to perform an official action within the scope of his/her authorities. Corruption is to steal from the citizens or companies in a country. The terms 'corruption' and 'fraud' are used here interchangeably. 'Corruption' takes place in the form of bribery, kickbacks, commissions, or other benefits without leaving any trace in the official records. 'Fraud' consists of deriving undue benefit by bypassing some controls or bending some rules. There remains some evidence in the records to trace the fraud.

An environment that is riddled with corruption poses a lot of challenges to the auditing profession. Most directors of companies operating in corrupt environments cook the books to hoodwink the investors and amass wealth to themselves to the detriment of the resource owners. In a similar development, corrupt government officials in most ministries, departments and agencies (MDAs) indulge in series of malfeasances to appropriate public wealth to themselves for self preservation. These corrupt practices precipitously militate against the work of an auditor thereby whittling down the reliability and relevance of audit report and by implication a loss of confidence in the auditing profession.

Corruption is a highly complex phenomenon. The parties involved leave very little tell tale in the form of irrefutable hard evidence. Most of the corruption takes place in an informal manner and under the dark cover of isolated contacts. At times it does not even require a spoken word. Mere eye contact can establish a relationship of corruption. The auditors find themselves at cross-purposes with the society. The social expectations are that the auditors should play an effective role in reducing, if not eliminating, corruption. The auditors, whose profession makes them concentrate on documentary or physical evidence, often find it hard to gather such evidence. They feel that they cannot do much about corruption. In such a situation, what precisely is the role of the auditors?

In their professional work, while working in a large bureaucratic organization or a government department, auditors may 'smell' corruption but feel that they are helpless to deal with it. They do not find handy tools in their tool-kit to handle the problem. Auditors know that they cannot physically see all transactions and all situations. An example is the bribe taken by a police constable from staff of company carrying the company's goods who has violated traffic signals. No one can ever detect it until the policeman is caught red-handed. The auditors are not in the business of catching people 'red-handed.' Thus, they cannot do much in such cases.

Similarly, the auditors do not deal with political, social, or cultural corruption. Even when we exclude these areas, the auditors still come across corruption in government offices and in large public and private organizations that fall under the purview of the auditors' routine work. There could be situations, in large public or private sector organizations and in government departments, where the rules and regulations are quite foolproof, yet corruption continues to flourish because of poor implementation. The auditors can point out these weaknesses as potential sources of corruption. The rules, regulations, procedures and operational standards of these organizations often leave lacunae, which create opportunities for corruption or at least protect corruption. Auditors deal with such phenomena.

However, corruption may remain hidden from auditors if the citizens are colluding with the public functionaries. For example, in case of a corrupt deal between an income tax officer and a businessman where the former reduces the tax obligation by accepting bribe from the latter, there is collusion between the two parties. None of them is likely to protest or reveal the deal. Both are benefiting from it. Such cases of collusion cannot be covered by any audit examination. The auditors of these organizations have a real challenge in auditing against corruption.

5. ROLE OF AUDITORS IN FIGHTING CORRUPTION

The auditing profession, as it has evolved, has its roots in the private sector where audit against corruption is not a serious concern of the stakeholders. They are more interested in fraud or theft of their assets. Corruption is not their worry, as who would bribe an employee of a private company for getting a service or buying a product? Corruption in private sector can take place when the top management decides to bribe government functionaries to get some benefits. In such a situation, why would they ask their auditors to report on corruption? The only situation when corruption could be of some concern for the stakeholders of private companies is when, in very large organizations, some of their employees try to receive bribe in procurement of goods and services and recruitment of staff. To control this type of corruption the private sector companies have evolved strong internal controls. Briefly, the methodology and standards of corruption auditing have not developed, since most of the standard setting in the auditing profession has taken place in the private sector and corruption has not been a concern of the private sector. In a very legitimate sense, corruption auditing is a concern of the government auditors or public sector internal auditors. Significantly, they have remained dormant in methodology development in this area.

Auditors may come across situations, during their examinations, which smack of corruption. Since investigation requires different standards and skills, the auditors cannot get into the business of investigating a suspected case of corruption. However, they can forward extracts of their reports to investigating agencies for further probe. As compared to auditing, investigation is a different area of oversight. However, auditors can play a vital role in assisting the agencies responsible for investigation against alleged cases of corruption. The investigating agency could be an internal entity, some anti-corruption commission, police, judiciary or a specialized body for a mega corruption case. The investigation may be initiated on a complaint from a citizen, employee, auditor or a supervisor in an organization. Internal auditors usually have more diversified and detailed knowledge of operations in different parts of the organization than the investigating agency staff that may be deployed only for a particular case. The internal auditors can assist the investigating staff in interpreting various rules, in explaining various practices, in sharing some of the confidential information that they may possess or discussing technical details of operations. The internal auditors can pinpoint areas of excessive cost and weaker controls which can help the investigating staff in detecting corruption.

6. THE WAY OUT

6.1 Auditors Responsibility

Due in part to the phenomenal losses in the industries, a controversy has existed concerning the role of the external auditor and the public's perception of that role. SAS No. 53, "The Auditors Responsibility to Detect and Report Errors and Irregularities," issued by the Accounting Standards Board (1988), was originally intended to address this problem. However, the Public Oversight Board of the AICPA SEC Practice Section concluded in 1993 that management believed that auditors had a greater responsibility for the detection of fraud than was currently being met. Business owners, legislators, judges, and the general public also share such beliefs. Most people do not realize what the responsibility of the auditor is. According to SAS No. 1, Codification of Auditing Standards and Procedures:

"The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud. Because of the nature of audit evidence and the characteristics of fraud, the auditor is able to obtain reasonable, but not absolute, assurance that material misstatements are detected. The auditor has no responsibility to plan and perform the audit to obtain reasonable assurance that misstatements, whether caused by error or fraud, that are not material to the financial statements are detected."

In an attempt to stifle criticism and appropriately respond to the public's demand for improved auditor performance, the American Institute of Certified Public Accountants issued SAS No. 82. The auditing standard details the auditor's responsibility to detect and report material misstatement in financial statements due to fraud. This is the first time the AICPA has used the word "fraud" rather than the more discreet word "irregularity." The two types of misstatement relevant to the auditor's consideration of fraud in a financial statement audit are those arising from fraudulent financial reporting and misappropriation of assets. The SAS was effective for financial statement audit periods ending on or after December 15, 1997.

Under SAS No. 82, the auditor has the responsibility to plan and perform an audit to obtain reasonable assurance about whether financial statements are free of material misstatement. The auditor is required to consider forty-one risk factors relating to fraudulent financial reporting and misappropriation of assets when designing an audit plan. Furthermore, the plan needs to be continuously modified during the audit on the basis of information gathered concerning these factors. The SAS has provided examples of conditions that would require reconsideration of an initial risk assessment. However, auditors must still use subjective judgment in analyzing the many risk factors. For example, one risk factor to be assessed by the auditor is "management displays a significant disregard to regulatory authorities" (SAS 82 1997: 90). However, the auditor must use "professional judgment" in conducting an audit where risk factors such as this are present and must document these risk factors in the work papers (SAS 82 1997: 90). Acknowledging that the difference between fraud and error is intent, the AICPA assigns the task of evaluating this difference to the auditor.

Similarly, the Private Securities Litigation Reform Act of 1995 imposes some of the same requirements on public company auditors. The requirements are as follows:

1. Audits must include procedures designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on financial statement amounts.
2. Each audit must include procedures to identify related-party transactions that are material.
3. Each audit must include an evaluation of the ability of the issuer of financial statements to continue as a going concern

6.2 Responsibilities of Management in Reducing Corruption

Given that professional accountants do not agree with the changed expectations of their role, and the limits on the auditor's possible role in controlling fraud, other considerations in the prevention and detection of corporate fraud should be discussed. These include managerial controls, employee screening, forensic accounting, and others.

Managerial Controls: Researches have shown that most organizations have the greatest median losses per capita occasioned by corrupt practices. The primary reason for this is because internal controls are less sophisticated and stringent in smaller organizations. So what, if any, are management's responsibilities when it comes to the prevention or detection of fraud? Annual reports of management clearly state that management is responsible for the preparation and integrity of the financial information presented, and the company and management maintain a system of internal controls to provide for administrative and accounting controls. All professional literature makes it clear that the responsibility of internal controls, proper reporting, and the adoption of sound accounting policies rests solely with management, not the auditors.

To combat the problem of fraud, a crucial element in deterring theft is strict internal controls, segregation of duties, and separation of functions. For example, simple procedures such as not letting the person writing the checks reconcile the bank statement, not letting the receiving department maintain physical inventory records, not letting the person initiating the purchase order approve the payment, and not letting the person maintaining the personnel database also issue payroll checks, may help separate incompatible functions within a business. Thus, internal controls may be strengthened and fraud deterred by separation of functions.

Screening: Another element to combat fraud is adequate employee screening. Although this statement might seem obvious, a good rule to follow to minimize the risk of fraud is to hire honest employees. There are many organizations specializing in pre-employment screening. These screening tests include lie detector and drug tests and fingerprinting of employees. Through adequate background checks of information on resumes and applications, an employer can elicit significantly more information and determine if the original information is accurate.

Organizational Climate: A third component to deterring fraud is creating a business environment that reduces the perceived need of a pressured employee to commit fraud. This environment includes creating open and consistent communications for hiring, evaluating employee performance, and assessing employees for promotion. These factors, along with counseling programs and employee enrichment efforts, might curtail the perceived need of an employee to commit fraud.

Finally, a few additional components to business fraud prevention include setting up a hotline whereby fellow employees can report improper conduct, having a high level employee review unopened bank statements monthly, establishing a written code of ethics, and making sure management level employees are role models. Although these additional practices may not seem important, they help establish the tone within the work environment and may help deter fraudulent activities (Jones 1996: 23).

7. CONCLUSION

Auditors should be able to protect and prevent intentional behavior and actions that undermined the will of the people, waste of public resources and activities that undermine accountability and transparency. This typically involves assuring that the right kind of controls is in place. Auditors must have a zero tolerance of corruption and should reduce improper payments each year that result from fraud, abuse and payments errors. This would lead to progress in building our economy.

Fraud and white collar crime have increased considerably over the last ten years, and professionals believe this trend is likely to continue. The cost to business and the public can only be estimated, as many crimes go unreported. However, the statistics we currently have show the astronomical values associated with fraud. Also, the expansion of computers into businesses may make organizations more vulnerable to fraud and abuse.

In order to combat fraud and white collar crime in businesses, a concerted effort must be exerted by the management of the business, the external auditors, and by all employees of the business. Everyone must realize that fraud is not a victimless crime. The cost of fraud and theft are shared by all through higher costs and lower corporate profits. Through adequate internal controls by management, better working environments for employees, more stringent requirements for external auditors, and codes of ethics for employees, everyone can start to combat frauds and defalcations within corporate Nigeria.

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