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I. INAUGURAL LECTURE FOR OPENING THE ACADEMIC YEAR 2013/2014

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FINANCIAL AUDIT UNDER CONDITIONS OF GLOBAL ECONOMIC CRISIS

The objective of an audit is to get a reasonable assurance that in the set of financial statements, as a whole, there are no significant distortions, irrespective of the fact whether they occurred because of mistakes or fraud. An audit has to increase future consumer's reliance on financial statements. This can be achieved if an auditor expresses his/her opinion about financial statements – whether they are prepared in compliance with established financial accounting procedures.

Financial audit has existed for many hundreds of years. The evaluation of it was always ambiguous. Nearly one hundred years ago there was a conflict between the possibilities of financial audit and financial information users' expectations. Very often we get information about the bankruptcy of legal entities with a long-term historical performance. A good textbook example could be the Enron company bankruptcy followed by Arthur Andersen, which was considered to be one of the strongest audit companies in the world. After the Enron bankruptcy, many companies in Europe and America went bankrupt. All these companies underwent audit and the majority had positive conclusions which were produced by auditors.

The talks about the importance of financial audit started when the economic crisis happened and many legal entities went bankrupt. Therefore, the question arises whether a financial audit is unreliable and it cannot disclose the facts which might be the causes of crisis and bankruptcies of companies. In order to answer this question, the reasons for crisis, bankruptcies, financial frauds must be investigated and, on the other hand, the capabilities of financial audits have to be clarified.

The main cause of crisis is disproportion of development between different countries, economic regions and world economy. The world

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economy is very different and negative tendencies are hardly noticeable. A good example of this is the economic crisis which started in 2008. Before the emergence of the crisis, nobody was aware of the negative symptoms. Even if somebody knew about it, it was not considered a big threat, e.g. in 2005 Alan Greenspan warned about a possible crisis in the real estate market. However, even after two years in 2007, the economic situation in the USA was considered to be good. One year later the economic crisis started in the USA, then it came to Europe and other parts of the world.

The negative phenomenon in economics could be compared to the waves in the sea. The sea is full of waves, but the storm does not happen. It begins when the waves reach a certain level and they enhance each other – new waves form such force which is hard to imagine.

A similar situation can be predicted in economics. While negative tendencies do not achieve a certain level, there do not exist any serious symptoms of crisis and when the symptoms do appear, there are no possibilities to stop the process.

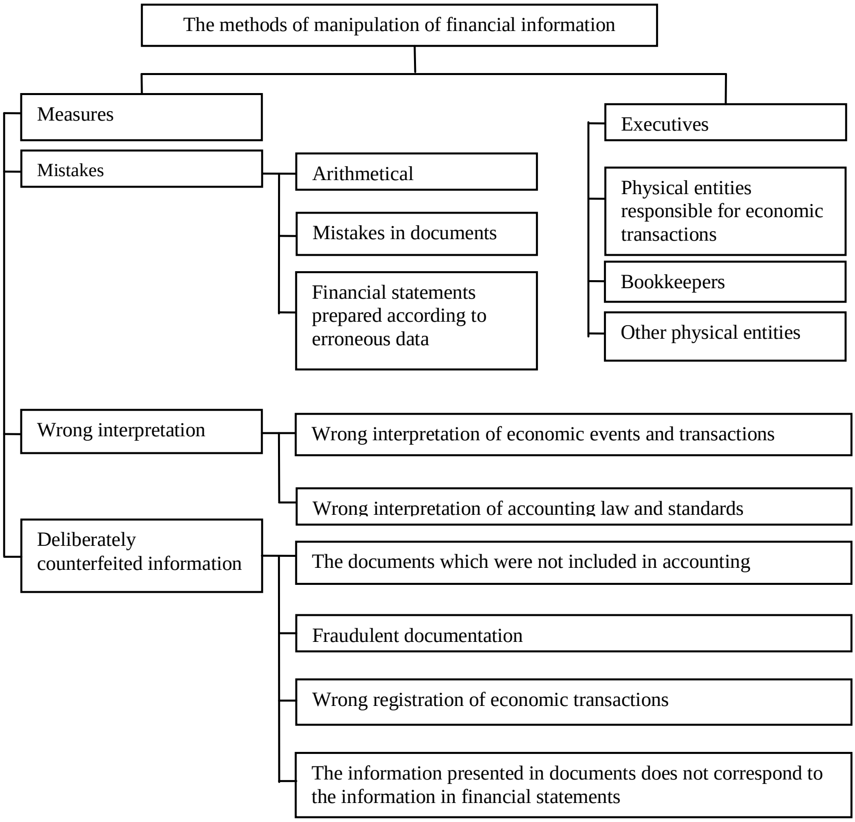
Consumer preferences are a big power which might destroy the economies of different countries and regions. A typical example could be the tulip crisis which happened in 1637 in Holland, when one tulip bulb, at the peak of that time, cost 10,000 guilders, i.e. the price of a house in those days. There is information that one brewer, in order to buy three tulip bulbs, sold his brewery. The outcome was very clear. The other example – today's crisis, the cause of which was the bubble in the real estate business. Neither the government, nor analysts or auditors can influence such a phenomenon.

Another group of reasons which cause economic development disproportions is closely linked with the violation of the code of ethics: it can be data manipulation, pressure, thefts. Financial fraud is the main threat and challenge which might be overcome by legal entities and governmental institutions. At the end of the 20th century a few scandals happened which brought about the sudden and unexpected collapses of powerful corporations.

Principally, accounting has to present true and reliable information about the assets of a legal entity, liabilities, performance results and cash flows on the basis of which financial statements are produced. But in practice, data manipulation of performance results, manipulations in asset and liability values occur more often. The table below depicts the methods of distortion of financial information.

Table 1

The methods of distortion of financial information



Financial information can be distorted in many ways: because of arithmetic mistakes in calculating total amounts, because of not depicting economic transactions in accounting, concealment of documents, presentation of economic transactions in accounts using counterfeited documents, misleading depiction of economic transactions in book – keeping, misleading interpretation of performed economic transactions, the conscious distortion of a company's financial state and performance results which are depicted in financial statements.

The biggest threat to a company and country's economic stability is the conscious forgery of documents, misleading depiction of economic transactions and economic activities in accounting, and the distortion of information in financial statements.

The causes of the conscious distortion of financial information could be a company‘s financial difficulties which appeared because of misleading evaluation of global competition, ineffective investments, the desire of top managers to show their exceptional management skills, fear of being made redundant because of bad performance results and because of some other internal reasons.

Internal causes can be as follows:

1. Misleading forecasts about the sales volume of new products. Lower than expected product demand which could be the cause of the investment which will never ever pay off and can worsen the financial position of a company. This might happen if companies start producing goods which have a low demand or because of a wrong assessment of the global competition. Therefore, the company’s managers try, at any cost, to hide the real picture and show that the financial position of a company is good.

2. The dependence of a managers’ salary on the achieved results, or a wish to maintain managerial position if it depends on the produced work results. It is obvious that performance results depend not only on management quality but on other factors as well.

3. Incompetent management. A very big threat occurs if the board is dominated by one or several people especially if the legal entities organizational structure is very complicated.

4. Low cost–effectiveness of a product because of the worsening market situation. Therefore, the legal entity can function up to the time if it is able to cover losses using internal resources, i.e. accumulated depreciation of fixed assets and reserves.

5. Shortage of effective control procedures of economic transactions, when the movement of documents is at fault, when the employees fail to understand the established order. Investigations made by many authors indicate that legal entities, where the internal control system is functioning well, suffer only a few cases of violations made by employees.

6. The difficult financial situation of a company appears because of complicated relations with the suppliers or buyers of produced goods – especially if a company has only one seller or one buyer, or one product, and banks do not provide credits being doubtful about the repayment of the loan. In this case, the managers try to hide information about the financial position in the company, expecting a better situation or hoping to find an additional investor.

7. Unstable company performance results. A company's performance is not always stable. Sometimes the company is performing very well, sometimes there can be stagnation and worsening results. If a company's performance results are not improving or are going down, all people concerned react sharply. This fact is indicated by the results of an investigation performed by the audit company Ernst & Young in Australia. The company's investors behaviour when the company did not get the planned profit was investigated. The company's share price fell by 8% during the first 24 hours. Similarly, the company's managers try to depict fictitious sales and profits or they try to minimize losses trying to show improvements in company performance. In some cases, everything is done on the contrary – financial statements depict a worse situation than it is in reality.

There are untypical cases of pressure on investors, creditors, sellers, buyers, governmental institutions and employees. Investors believe that a company which they have invested into will manage the capital rationally and will generate profit and will increase the company's value. Creditors are interested in the repayment of the loans and interest on time. The sellers want to be sure that a company will meet all liabilities on time. The buyers want to have long–term cooperation with a legal entity. Governmental institutions are keen on the company's stable development and ability to pay taxes. Employees seek stability and guarantees for the future. Members of society wish to have opportunities to find a job and hope for the better development of infrastructure.

A very serious and growing threat for company stability is breach of trust. The results of the latest investigation, which was conducted by PricewaterhouseCoopers, indicate that 34% of companies stated that they came across the phenomenon of a breach of trust. This is 13% more than one year ago. 56% of breach of trust was performed by the company's employees, 40% by other people and 4% of fraud perpetrators were not disclosed. In Poland, about 42% of crimes are performed by company employees. These crimes are performed by top and middle managers. This makes about 69% of internal complications.

The investigation results of other institutions were very similar, e.g. the Association of Certified Fraud Examiners state that the average total loss because of breach of trust makes up 5–6% of company's revenue in the USA. In 1996 such losses amounted to 400 bn. dollars, in 2002 – 600 bns dollars, in 2006 – 652 bns dollars.

The COSO (Committee of Sponsoring Organization of the Treadway Commission) investigations indicate that the main calculating offenders were regular employees; the losses they made, in average, were about 62,250 dollars per case. The losses which were made because of managers ambiguities were about 140,000 dollars per case. Losses which were made because of the defrauding of owners and executive managers were about 900,000 dollars per case. The managers of the companies were the main participants in all frauds which happened in the 21st century.

Therefore the question arises whether accounting and audit can save the economy from similar cataclysms, crises and counterfeiting. There is no single answer to this question. Accounting is standardized internationally and locally. At the beginning, when the idea of creating accounting and audit standards appeared, it was considered that standards would help to avoid or decrease the number of frauds and manipulations. But, on the other hand, there are spheres which cannot be standardized. This is closely linked with the assessment of the position of financial statements. Some positions are difficult to assess exactly, only approximately. It is impossible to create such standards where all possible cases can be foreseen. It is difficult to say what might happen if accounting and audit standards did not exist.

Investigations done by the Association of Certified Fraud Examiners (in the U.S.) state that most of the violations (about 60–65%) were disclosed when the employees detected fraud, 18.4% – by internal control and 11–12% by internal auditors.

Several causes stipulate this position:

1. Audit standards require that auditors should check the financial statements and present their opinion whether these financial statements depict a true and fair view of a company. An auditor has to collect evidence which confirms that financial statements generally do not indicate significant distortions. The auditor proves that he/she evaluates internal control. But, on the other hand, an auditor does not identify the primary documents.

2. Large competition among audit firms. In order to survive in the market, audit firms have to evaluate the fact that the payment for complicated audit services increases slower than the economic activity which becomes more and more complicated. Therefore it is important to look for new rationalization methods of audit procedures, but, on the other hand, it is not always justified.

3. A weak side of audit is that audit firms get the payment from the legal entities they audit. The amounts are big, e.g. Enron in 2000 paid 25 million dollars for audits and 27 million dollars for a consultation to Arthur

Andersen, which does not exist anymore. Today, the payment for auditing is about 35 million dollars or even more per year. It is said that if an auditor presents a conclusion which is not agreed upon by the legal entity, then, sooner or later, the contract may be breached and the audit firm will lose the possibility to earn money.

The manipulation of financial information can bring a temporary effect. Distorted and embellished data can increase investors' activity, but later the situation can become very complicated because some manipulations are related with additional costs and the necessity to pay taxes for an unreasonably approved higher asset value or profit which is not gained by the company.

Financial fraud leads to unsuitable investment decisions and financial markets asymmetry. It is considered that the distortion of data in financial statements can cause 500–1000 times bigger losses than the distorted amount.

International institutions and governments of different countries are looking for ways how to improve the situation. In 2002 in the USA, the Sarbanes Oxley Act was passed. This act instigated a stricter control of audit companies, increased the responsibility for presenting false information and improper internal control. A new institution, the Public Company Accounting Oversight Board was founded. This institution controls if the Sarbanes Oxley Act requirements are being carried out.

The EU directive No. 8, 2006, was replaced by directive No. 43. In the new directive, much more attention is paid to audit quality control, especially in entities of public interest. But even today the situation is unsatisfactory. Therefore, the European Commission is talking about the possibilities of changing some regulations of the directive. The reasons for the anticipated changes are as follows:

- Auditor's role and audit quality imperfection under conditions of world financial crisis.
- The threat of excessive cognition.
- The lack of skepticism during audit process.
- Expectation gap between audit service customer and consumer.
- Providing non–audit services to audit customers.
- Too little cooperation between auditors and supervisory institutions.
- Auditors' conclusions do not meet consumer expectations.
- Small audit enterprises experience discrimination.

- “The Big Four” – Deloitte, Ernst&Young, KPMG, PricewaterhouseCoopers dominate the audit market: they audit 83% of companies in the EU, 85% in USA and 14% of companies in China which are listed on stock exchanges.
- The auditing quality is not always satisfactory, e.g. in Germany the following number of bad quality audits was defined: in 2009 – 19%, 2010 – 24%, 2011 – 27%, therefore the audit companies underwent disciplinary punishment.
- Some countries supervisory authorities do not control the quality of audits.
- The auditors–practitioners check the quality of audit in other audit companies.
- The order of audit quality supervision in different countries is not the same.
- The auditors working in one of the EU countries practically cannot provide audit services in other countries.

The European Commission intends to submit the following proposals:

- To allow to acquire 50% of audit company shares to non–auditors.
- The auditors providing audit services in one of the EU countries could provide audit services in other country if the partner is considered to be a primary one.
- An auditor providing audit services in one of the EU countries will be acknowledged in other country if he/she undergoes a three year adaptation period and passes a unified test.
- Audit quality will be controlled only by the public audit supervision institution.
- Under the name of the public audit supervision institution, the audit quality can be checked only by people who do not participate in the audit process.

It is foreseen that audit companies have no right to provide expert services which are related with management and taxation, to manage accounting and prepare financial statements, to develop and implement internal control systems, to provide such services as evaluating company’s assets, to develop and implement information systems in public sector.

The proposed developments should improve audit quality. However, it would not eliminate some negative tendencies. In the global world, economic transactions have become more diversified and more complicated. As is known, an audit performs a secondary function. If the economic activity is not functioning the audit does not exist too. The auditors fail to know in advance what methods of fraud and manipulation are possible. Even if the spheres of risk are known, there is no guarantee that the risk will be evaluated properly.

There are some objective restrictions on financial information quality. These restrictions occur due to the situation in the markets. Between the moment when the financial year comes to an end, and the time when the financial statements are presented, some months go by and during this period the situation in the market can undergo changes, too. This means that if the consumer concerned receives reliable information it does not mean that after a certain period of time this information will be current. On the other hand, there exist some rational restrictions on presenting qualitative information. Firstly, there exists the ratio of information obtained and its quality. Secondly – the timeliness of information is of great importance too. It is much better to get indicative information when it is needed, rather than to get accurate information later.