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Briefing

The Audit Implosion: regulating risk from the inside

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The Audit Implosion: regulating risk from the inside

Commentary on the recent transformations in professional services within, and around, the financial audit process.

There can be little doubt that the landscape of financial auditing in North America and the UK is changing rapidly. It is not only the large firms who are redesigning their audit services within a broader portfolio of advisory activities. Judging from the interest shown by many Institute members in the idea of 'tomorrow's audit', many accounting practitioners in smaller firms also wish to design more client value into the audit process. These changes are on going and auditing gurus like Robert Elliot are important catalysts for a new way of talking about financial auditing practice. By promoting changes in concepts and vocabulary, changes in concrete practice are made possible.

In this briefing I provide a short commentary on the recent transformations in professional services within, and around, the financial audit process. Of particular significance are developments in risk management advisory services, which have their origins in an intensified regulatory and corporate interest in internal control. These changes can be described as an 'audit implosion', a motif which refers to thirteen overlapping ideas:

1. The 'regulatisation' of the private organisation

It is necessary to understand the broader system within which financial auditing is positioned. This system includes regulatory authorities, which are adopting a more explicit 'compliance-oriented' approach to regulation, and which rely increasingly on the self-organising capacities of organisations. From this point of view non-statutory voluntaristic schemes, like the Combined Code on corporate governance, represent a new style of regulating the organisation. For such a style to succeed, the inside of organisations and their internal control systems must be reconceptualised as a potential 'regulatory space'. However, the point is not to control the corporation with more regulation from the outside, but to encourage the development of a transparent inner space for self-regulatory capacity.

2. The marginalisation of compliance-based regulation

One aspect of the above mentioned substitution of self-regulatory activity for external regulation is the project to align business self-interest and regulatory objectives. If regulatory ideals can be made compatible with business objectives, then the problem of regulatory compliance literally disappears. Perfect alignment would mean that the organisation would not understand or see itself as 'complying' with external regulations but simply as carrying on its core business. The organisational internal control system is one of the most important places where this ideal, fanciful as it may sound, can be pursued, thereby potentially marginalising the age-old problem of regulatory compliance.

3. The reinvention of financial audit as a by-product of business services

The trends described in 1 and 2 above provide the context for specific changes in financial auditing. It seems evident that the distinction between consulting and auditing is becoming more unclear as consulting imperatives are being designed into the financial audit process. Whereas, in the past, additional services might emerge from the financial audit through the mechanism of a letter of weakness or something similar, the new ways of talking about auditing are beginning to conceive of the statutory audit as a by-product of client servicing.

4. The audit planning process as a stand-alone service line

An important illustration of point 3 above is the manner in which, as more audit time and effort is being invested in understanding the client business and associated risks, audit planning is emerging as a discrete product line in its own right. This is particularly evident in the emphasis of the Institute's Audit Faculty roadshow on 'tomorrow's audit'; Business Risk Assessment (BRA) is simultaneously both an audit planning tool and an advisory mechanism.

5. The alignment of control objectives and corporate strategy

From a close examination of a number of new audit approaches by the large firms, it is also evident that an attempt is being made to position the audit process closer to the strategic dimensions of the audited organisation. This has grown out of the normal audit requirement to understand the business. For example, the Business Measurement Process articulated by KPMG projects a close alignment of control and strategy objectives, in which control is an integrated part of ensuring the realisation of corporate strategy. In 2 above it is suggested that regulators may wish to build control objectives into organisations. The large accounting firms will be agents of this kind of change by shifting auditing into the core conceptual space of business strategy.

6. The marginalisation of the problem of auditor independence?

Perhaps one of the most contentious aspects of the 'audit implosion' concerns its implications for independence. Independence in the sense of a sharp separation between audit and consulting services is being designed out of existence. To put the point in another way, certain non-audit services are being designed into the audit process itself in a manner which makes this aspect of the independence discussion potentially redundant. Of course, regulators in the UK and USA are still very much concerned about auditor independence and arrangements for securing it. The complex implications for independence arising from the audit redesign process are also reflected in increasing efforts in the UK and USA to re-brand independence, in the sense of objectivity, as a core professional competence.

7. The adaptation of core financial auditing competencies for other services

It is also evident from some of the internal restructuring of the large accounting firms that new service lines are being developed adjacent to financial auditing and borrowing from the traditional skills base in internal control evaluation.

The COSO framework, developed in the United States, provides a conceptualisation of internal control which is also potentially a varied field of new assurance and advisory services. While the larger firms have adapted and refined this framework for their own proprietorial services, it represents both an opening out of the different dimensions of internal control as a market for advice and a challenge to the role and position of traditional financial statement auditing.

8. The intensifying 'responsibilisation' of Directors.

Another important demand side dimension of the audit implosion and the market for new services is the emergence of Directors as regulatory agents. In 1 above it was suggested that the corporation is being constructed as a self-regulatory space. The role of Directors is evolving as part of this project. Though Directors have often complained about over-regulation, many of the changes described above are premised on an intensification of the regulatory role of Directors outside of the statutory system. So, changes will not necessarily be experienced as regulation from outside. Rather, the 'responsibilisation' of Directors in this sense is intended to activate them as corporate agents of self-organisation, through which new variants of financial auditing and assurance services can operate.

9. The emergence of the management consultant as de facto regulator

The redesign of financial auditing, the growth of audit-related services and the alignment of control and strategy suggest a blurring of traditional roles. It is no longer possible to distinguish sharply between consulting and auditing. As regulators place increasing reliance upon the control systems at the organisational level, giving up on central control in favour of limited back-testing of organisation-based controls, management consultants will acquire a de facto role in regulation, as advisers in a market for self-organisation services.

10. The flight from professional opinion

One side effect of the audit implosion is an implosion of professional opinion. This is already visible in the problems of defining and reporting on the effectiveness of internal control systems. Professional opinions in the shadow of litigation, even at the level of internal accountability, become shallow, defensively negative and unhelpful. This is an important threat to the emerging climate promoting self-organising regulatory activity beyond the state. The legitimacy of this style of regulating depends upon accompanying forms of organisational transparency and accountability.

11. The dispersion and de-departmentalisation of audit activity

Practices of Control Risk Self-Assessment (CRSA) have a long history but have received a new stimulus from the corporate governance revolution that is now taking place. CRSA represents an important pressure for change in controlling activity and has been consistently critical of narrow, periodic forms of audit. In essence, CRSA borrows from the language and philosophy of quality assurance and argues for the location and ownership of control functions as close as possible to operational processes. In short, it seeks to build control values into operations. This represents a radical programme for dispersing control activity throughout the organisation in an integrated manner, as opposed to having separate audit and control departments charged with this role. From this point of view, internal auditing and related activities will eventually have a higher order 'control of control', or review function, which will also facilitate risk recognition and ownership throughout the organisation.

12. The transfer of non-routine assurance functions from the external to the internal auditor

While internal auditors may be responding to the challenge of CRSA and of providing high level oversight of a broadly defined internal control system, their relationship with external auditors is also evolving. No longer merely a basis for reducing the external audit fee, internal auditors seem likely to play an increasing role in the self-organisation of regulatory activity in companies. This will accelerate the transformation of the traditional financial audit process in the direction identified in point 3 above. One would also expect to see a more competitive relation between internal and external auditors as each strives to be the pre-eminent corporate risk management advisor.

13. The fragmentation of the financial audit process into discrete services and the creation of competitive sub-fields in risk management

Overall, the shape of a competitive field for risk management services is becoming visible. Professional turf battles may even be played out within the large firms themselves as they create internal structures to differentiate product lines which nevertheless overlap. The emerging market for control and assurance services is also an opportunity for professional re-design, particularly for internal auditors. In short, we can expect to see considerable competition for pre-eminence in the market for designing and servicing the internal regulatory space of corporations.

It is always risky for an academic to comment on complex developments in professional practice. However, there is also some merit in standing back and reflecting on these changes. I also suspect that many practitioners will agree with most of the substance of each individual observation, despite the liberties that I have taken with the English language. Furthermore, the whole is also greater than the sum of the parts. The thirteen arguments, taken together, suggest that something systematic, a financial auditing 'implosion', is occurring which is not well understood. While it has become conventional to explain these changes in terms of the need to adapt auditing to the needs of the market, there are other factors in play. In my view, it is impossible to understand the pressures for change in financial auditing without also referring to background changes in the regulatory style of the state. However, despite the apparent rapidity of changes in and around financial auditing, it is always dangerous to equate talk of change with change at the level of practice itself. We are still at a very early stage of practice development and the thirteen themes identified above, being speculative in nature, require to be substantiated by more empirical investigation.

About the author

Michael Power is P.D Leake Professor of Accounting at the London School of Economics and Political Science and author of The Audit Society (Oxford University Press, 2nd edition 1999). This essay is a summary of the the first Chartered Accountants' Trustees Limited Lecture, presented at Chartered Accountants' Hall, London on December 1 1998.

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