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Auditors at the Crossroads

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> "Sustainability reporting and disclosure should have independent assurance. A formal process of assurance by an independent party is essential for impartial sustainability reporting. Sustainability reports should clearly state the name of the assuror. Integrated reporting should be assisted by the Audit Committee." [South African Institute of Chartered Accountants, Summary of Report on Governance for South Africa – 2009 (King III), King Committee on Governance, Principle 6.5.]

Developing Challenges to Audit Usefulness

Enron, WorldCom, Lehman Brothers, Bear Stearns, Massey Energy, British Petroleum. Each of these companies is associated with massive destruction of corporate and social value during the first decade of the 21st century. They all harbored unrecognized risks and presented public images that disguised the real dangers of their business models. Nevertheless, in retrospect, warning signs were plentiful and obvious at each company long before disaster struck.

Unhealthy companies often exhibit symptoms like poor internal controls, misaligned incentives, myopic business plans, inadequate risk management, deficient implementation procedures and corrupt company culture. These and other forewarnings were evident in the lead-up to most recent crises. Unfortunately, such signs are often missed by auditors and ignored by stakeholders, neither of which are trained, nor provided with sufficient information, to recognize the significance of sustainability risk indicators.

As you read this, similar predictable and devastating financial disasters are likely building in the economy, perhaps in your investment portfolio. They might be obvious to risk managers, financial analysts, organizational behavior specialists and others who are trained to look forward, as well as backward, when examining company information. However, without strategic deployment of those professionals in the financial services industry, predictable disasters will go largely

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undetected until damage has been done.

The European Commission, in an October 2010 press release announcing a public consultation on the audit function, explained its response to events of the last few years. "In the wake of the financial crisis, we need to ask the question whether the role of auditors can be enhanced to mitigate any new financial risk in the future."[2] The Society of Actuaries has even responded to recent circumstances by establishing a new professional credential of Chartered Enterprise Risk Analyst.[3]

Indeed, reliance solely on backward-looking and silo-based financial measures to evaluate the status and health of companies is becoming outdated. Tools established for industrial companies in the cultural context of the 19th and 20th centuries are simply inadequate for the 21st century.[4] How will the audit industry evolve in response to challenges presented by these trends?

A More Useful Paradigm

Integrated reporting presents an opportunity for the audit profession to rethink its future direction. As corporate directors, investors and other company stakeholders develop more interest in holistic company reporting on sustainability, the need for independent assurance of reporting reliability will continue to expand beyond examination of measures relating to historical company financial performance.[5] Will audit firms cede this territory to other service providers that assemble the expertise needed to evaluate those reports?

To win the contest for expanded assurance assignments, audit firms might first re-visit the paradigm that underlies their service model. Audits currently evoke the image of an inspection, perhaps a regulator, going through a checklist to ensure compliance with required items. The process is backward-looking and focused more on financial data or operational procedures than the human behaviors and organizational dynamics associated with items on the checklist.

If the goal is to maximize usefulness of audit assurance services in a world becoming more concerned about sustainability and enterprise risk exposures, a physician paradigm might be more appropriate. By viewing goals of the audit examination more holistically, value of the service to directors, investors and other company stakeholders could be greatly enhanced.

Which paradigm better fits the needs of audit report users: (a) a regulatory compliance inspection; or (b) a company physical health examination? The medical paradigm contemplates evaluation of not only blood test results (i.e.,

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financial performance numbers), but also consideration of behavioral and genetic risk factors (i.e., organizational design, environmental issues, implementation procedures and company culture) in a forward-looking evaluation concerned with ongoing health and sustainability. It recognizes the potential for use of specialized expertise tailored to unique company characteristics. It also acknowledges that companies are made up of human beings and resemble organic systems more than predictable machines.

Paradigms can be powerful in framing expectations and guiding the execution of responsibilities. A paradigm shift could do wonders for the audit profession. It would force audit firms to integrate their established accounting acumen with expertise in risk management, organizational behavior and other disciplines that bear on assessing the accuracy and completeness of company integrated business sustainability reports. If this can be done, the future benefits of a more useful annual company audit examination could be enormous.

Then again, perhaps actuaries with the Chartered Enterprise Risk Analyst designation would be better up to the task?[6]

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[2] October 13, 2010 European Commission press release announcing a public consultation on how the statutory audit could be improved.

[3] See < https://www.ceranalyst.org/>, viewed on November 5, 2010.

[4] For example, the Ontario Securities Commission, in "*OSC Corporate Sustainability Reporting Initiative - Report to Minister of Finance*," (December 18, 2009) reported that, "During our consultations, stakeholders expressed concerns regarding the adequacy of corporate governance and environmental disclosure. In particular, they noted that . . . in the case of environmental disclosure, the information is often not integrated with financial reporting, nor is it typically audited or verified by an external party."

[5] Growing perceptions of the importance of sustainability is illustrated by the UN Global Compact-Accenture CEO Study 2010, "*A New Era of Sustainability*." It reported, "CEOs around the world are starting to see the shape of a new era of sustainability coming into view. In the face of rising global competition, technological change and the most serious economic downturn in nearly a century, corporate commitment to the principles of sustainability remains strong throughout the world: 93 percent of CEOs see sustainability as important to their

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company's future success."

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