Changing role of an auditor – What do you expect from them?

Every time a financial scandal breaks out anywhere in the world, a furious debate arises on who should have been responsible for detecting the fraud and how was this missed? The other debate revolves around how many more laws need to be instituted so that such a debacle never happens. The common refrain, irrespective of where in the world such a debacle takes place is, "what was the auditor doing?"

Public opinion following such debacles is built in most countries—and India is no exception—through extensive coverage by the media. Armed with research which is often best described as rudimentary, the Indian media expresses personal opinions as news on subjects that are complex and difficult. Opinions are formed and positions are taken on national television and newspapers based on conjectures, speculation and imagination. The facts and data may not be available to the extent that a reasonable opinion can be formed but in a race to get the eyeballs to the latest 'breaking' news sometimes leads to manufacturing news rather than presenting facts. The verdict by the media is out and the auditor is pronounced guilty even before he is allowed to utter a single word in his defense.

Worse, as adverse public opinion is built up by sensational reporting and a media trial, the regulatory and government institutions come under intense pressure to be seen to be taking action.

But what does an auditor really do? The word audit is derived from the Latin word "audire" which means to listen. In early days, the role of an auditor would be to listen to the conversation between book keepers and then report to the royal courts or the business owners on the accuracy of the books of account.

Auditing is one of the oldest professions in the history of civilization. Archaeologists have found evidence in the form of ticks, circles etc., pointing out to the existence of auditing, even in the remnants of the records of trade and commerce during the Mesopotamian period of about 5000 BC. The Mauryan dynasty (about 350 BC) had a robust system of accounting and auditing emanating from the works of Kautilya in Arthashastra. India does have a rich history of auditing going back many centuries.

Audit – A reasonable assurance engagement

There is usually a gap in the understanding as to who actually prepares a set of financial statements and what does an auditor do in respect of these statements. The Institute of Chartered Accountants of India's (ICAI) Auditing and Assurance Standard (AAS) 28 defines that the responsibility of the financial statements is that of the management and goes on to state that "financial statements are the representations of management.

The preparation of such statements requires management to make significant accounting estimates and judgments, as well as to determine the appropriate accounting principles and methods used in preparation of the financial statements. In contrast, the auditor's responsibility is to audit these financial statements in order to express an opinion thereon".

ICAI also states that "an auditor cannot obtain absolute assurance that material misstatements in the financial statements will be detected. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements will not be detected, even though the audit is properly planned and performed in accordance with the auditing standards generally accepted in India. An audit does not guarantee that all material misstatements will be detected because of such factors as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature. For these reasons, the auditor is able to obtain only a reasonable assurance that material misstatements in the financial statements will be detected".

The auditor's opinion on financial statements provides users with a high, ***but not absolute***, level of assurance. Absolute assurance in auditing is not attainable because of such limiting factors as the prevalence of assessments, uncertainties and estimates which are integral to a financial statement. These are also subject to significant judgment exercised by the preparer and the auditor.

Financial statements also contain approximation, not merely exact amounts with respect to many items especially depreciation, provision for bad and doubtful assets, impairments, estimates, evaluation of uncertainties etc. This is a risk all users of financial statements carry with themselves. The concept of reasonable assurance, therefore, does not ensure or guarantee the complete accuracy of the financial statements.

If the expectation of the society is to obtain a certificate of accuracy from an auditor on the financial statements, then the rules of auditing need to be re-written and this will have a significant bearing on time required to prepare such accounts and costs relating to issue of financial statements.

Responsibility of those charged with governance and of management

The primary responsibility for the prevention and detection of fraud and error rests with both those charged with the governance and the management of an entity. The respective responsibilities of those charged with governance and management may vary from entity to entity. Management, with the oversight of those charged with governance, needs to set the proper tone, create and maintain a culture of honesty and high ethics, and establish appropriate controls to prevent and detect fraud and error within the entity.

It is the responsibility of those charged with governance of an entity to ensure, through oversight of management, the integrity of an entity's accounting and financial reporting systems and that appropriate controls are in place, including those for monitoring risk, financial control and compliance with the laws and regulations.

It is the responsibility of the management of an entity to establish a control environment and maintain policies and procedures to assist in achieving the objective of ensuring, as far as possible, the orderly and efficient conduct of the entity's business. This responsibility includes implementing and ensuring the continued operation of accounting and internal control systems, which are designed to prevent and detect fraud and error. Such systems reduce but do not eliminate the risk of misstatements, whether caused by fraud or error. Accordingly, management assumes responsibility for any remaining risk.

Inherent limitations of an audit

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The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting a material misstatement resulting from error because fraud, generally involves sophisticated and carefully organised schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that evidence is persuasive when it is, in fact, false. The auditor’s ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those involved. Audit procedures that are effective for detecting an error may be ineffective for detecting fraud.

What do you expect from an auditor?

Every time a large fraud is detected anywhere in the world, the role of the auditor comes under the scanner. Speculation becomes rife about the role of auditors, their competence or independence and other aspects of auditing, like the quality of evidence and extent of verification. Auditing in current times of information technology itself is a fairly complex process. The audit professionals and their governing bodies around the world would lead you to the audit reports and the standards and practices that an auditor follows, which explicitly state that auditor’s tests are not designed to detect fraud in the normal course.

These are designed to give a reasonable reassurance on the financial statements as against a certificate of correctness. It is the management, under various laws including the Companies Act and Clause 49 of the Listing Agreement that is responsible for maintaining books of account that reflect the true state of affairs and the income of a company.

Auditors have this unique responsibility and consequent liability towards all stakeholders who may rely on an audit report. This includes shareholders, investors, creditors, government, employees, tax authorities, environmental groups and in cases like Satyam, to the society at large and it extends across geographies. There is no other professional discipline be it a doctor, lawyer, engineer etc., in which a practitioner normally accepts such liabilities or responsibilities to stakeholders beyond the client.

If the role and responsibility of the auditor is not defined and in some ways limited, it casts an unusually high expectation from the auditor to uncover all fraud and material mis-statements, which will be a forensic investigation rather than a statutory audit. This is counter-productive and would raise the cost of compliance and the time required to unusually high proportions.

The audit report signifies that the auditor has reached a conclusion to give the users a reasonable assurance on the income/loss or the state of affairs (balance sheet) of an entity. In doing so, he follows the standards prescribed by ICAI, which are the performance benchmarks of best practices to enable an auditor to discharge his duties. In carrying out his duties, he would be expected to follow the principles of 'due care', which is met by following those prescribed standards in an effective manner.

There are additional standards and guidance on the responsibilities of firm personnel regarding quality control procedures for specific types of engagements are set out in other pronouncements of the Auditing and Assurance Standards Board (AASB) issued under the authority of the Council. For example, Standard on Auditing (SA) 220, "Quality Control for Audit Work", establishes standards and provides guidance on quality control procedures for audits of historical financial information.

The firm should establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm or engagement partner(s) are appropriate in the circumstances. This is an over arching requirement for all auditors to comply with.

A key element of an auditor's responsibility is to show professional skepticism in dealing with the appropriate evidence he tests to support his conclusions. The principles of professional skepticism can be best described as 'trust but verify'. There is a need to go beyond the obvious explanations that a reasonable person is expected to do in his line of duty.

However, an audit is not an investigation and the framework of audit is built on trust. If the need is to have a forensic audit embodied in a statutory audit that would double guess all management actions including controls with a view of uncovering a potential fraud, then the auditing rules need to be re-drawn. Today in India, as in the rest of the world, an audit opinion is built on the premise of reasonable assurance to the intended users.

Auditor's responsibility in a case of management fraud

The risks of fraud are inherent to any commercial enterprise and its financial results.   KPMG, in their India Fraud Survey Report, 2008 state that only 4% of the frauds are detected by the statutory auditors while about 60% is detected by internal processes and audits and 36% is through accidents or tip offs.

In the event of a management fraud of massive scale, it is quite common to jump to the conclusion of the auditor being conniving with the perpetrators or being grossly negligent. A well concealed management fraud carried out by persons whose reputation is seemingly beyond reproach is difficult to unearth. The company could also have independent directors who are luminaries in their respective fields and internal systems, controls and internal audit functions which have received awards from reputed international institutes. All these factors create an environment of good controls and it gets very difficult to detect fraud especially if the evidence is being fabricated and forged.

ICAI, in AAS4 – Auditors' responsibility on error and fraud states that "fraud, generally, involves sophisticated and carefully organised schemes designed to conceal it, such as forgery, deliberate failure to record transactions, or intentional misrepresentations being made to the auditor. Such attempts at concealment may be even more difficult to detect when accompanied by collusion. Collusion may cause the auditor to believe that evidence is persuasive when it is, in fact, false. The auditor's ability to detect a fraud depends on factors such as the skillfulness of the perpetrator, the frequency and extent of manipulation, the degree of collusion involved, the relative size of individual amounts manipulated, and the seniority of those involved. Audit procedures that are effective for detecting an error may be ineffective for detecting fraud".

ICAI also states,"however, unless the audit reveals evidence to the contrary, the auditor is entitled to accept records and documents and genuine. Accordingly, an audit performed in accordance with auditing standards generally accepted in India rarely contemplate authentication of documentation, nor are auditors trained as, or expected to be, experts in such authentication".

Do Audit Regulations Need Overhauling?

Indian Auditing Standards are issued by the Institute of Chartered Accountants of India ('Institute or ICAI') and are drawn from the International Standards of Auditing, which are the global standards of auditing. There are further standards on quality controls and oversight. The oversight mechanism includes Peer Review of a firm by another firm of chartered accountants approved by the Institute and the Quality Review Board is entrusted to review quality of services provided by a CA including audit services. All members of ICAI, which includes auditors are subject to disciplinary jurisdiction of the Institute. The Financial Reporting Review Board of ICAI reviews a sample of financial reports for improvements.

Securities and Exchange Board of India (SEBI), Ministry of Company Affairs (MCA), Reserve Bank of India (RBI), Comptroller & Auditor General of India (CAG), Income Tax authorities etc.

do have an influence on the overall audit process conducted by an auditor. Some of these bodies also monitor progress and take action against chartered accountants found deficient in their duties. The board and the independent directors under Clause 49 have a responsibility to review and question the auditors and the audit committee, having independent directors review the quality of auditors' work every year before they are put up for re-appointment. These gatekeepers do make the process fairly robust as envisaged but it is in the details where the cracks appear

There are enough regulations to oversee commercial and corporate activities in the country but if these do not seem to prevent economic crises maybe we need to look at improving the enforcement of laws. Clamor for more regulation is akin to reacting to financial debacles through knee jerk reactions. Such reactions put in place new regulations in a hurried manner like SoX till the next debacle happens. Tighter regulations do not prevent intentional mis-statements or newer frauds from being committed - Madoff, Refco, Fannie Mae, Shell, Satyam happened after SoX and Clause 49 were in force. The best of laws will not help if these are not practiced on the ground level by businesses and if infarctions are not dealt with swiftly and transparently. In fact, what we need is a more streamlined and efficient system of regulatory and supervisory mechanism that performs effective oversight, not more regulations.

In conclusion

There is an irrational expectation from all stakeholders – the investors, lenders, employees, society, regulators and even the company's management and its directors that a set of audited accounts is a certificate of correctness of all information that is reflected therein. Audit is a complex process by which an auditor determines the risks associated with each account balance or the inherent controls built to mitigate the risks and the risks of failing to detect any material misstatement. He then plans a strategy to give himself a reasonable comfort on the accounts, tests the assumptions and documents the results. These collectively provide a basis for his opinion to give a reasonable assurance.

All societies create interplay between a number of gate-keepers to keep the financial markets safe and healthy. The gate-keepers in the financial world include the company and the management themselves, the board including independent directors, internal auditors, external auditors, regulators, market and fiscal agencies, law enforcement agencies, etc.
The gatekeepers collectively play the role of keeping vigil on the markets. Audit is a deterrent but not a guarantee that no financial misstatements are embodied in a financial statement. Very much like the presence of law enforcement does not guarantee that no crime would take place. The gatekeepers, by being diligent reduce the risk of debacles, but often human greed overpowers all rational judgment and induces them to indulge in fraudulent acts, knowing fully well that some of these acts have prison sentences that could extend to almost one's entire life.

The auditor in many cases is also a victim of fraud and merely by virtue of being an auditor and society should not assume their hand in conspiracy till otherwise proven in a court of law. Till then, the auditor too has the right to be innocent till proven guilty.

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