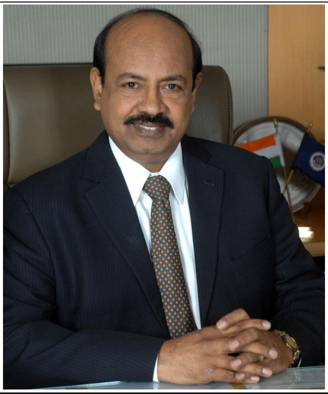
Role of Auditors in Capital Markets



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1. World over extensive research has been done to study the relationship that exists between capital markets and national and global economic growth. Research has proved the critical role that capital markets play in fostering economic growth. In fact, efficient allocation of scarce resources emerges as one of the main function performed by a capital market. These markets channelise the funds available with the investors in the economy to productive use by entrepreneurs.[1] As a corollary to their main function, well developed capital markets, thus, are able to encourage increased savings in the economy and convert these savings into capital for productive investments. Thus, they are able to exercise direct influence on the rate of savings and investments in the economy. Incidental to this, capital markets also help diversification of risk in the economy.[2] Such significant function of allocation of resources is directly dependent upon the information which forms the basis for economic decision making. In fact, the funds allocated based on the wrong information would on the one hand shall yield no result and on the other hand another deserving project would be deprived of the funds. It is in this context, the auditor's role is quite crucial because it is the auditor who lends creditability to financial information through expression of his opinion on the financial statements.

2. In addition, a number of other benefits also seem to accrue to the economies having well developed capital market. The beneficiaries include not only the entrepreneurs who can enjoy greater access to capital at lower cost, but also the public at large, which on the one hand enjoys a variety of job opportunities generated from a robust financial services industry that forms the backbone of the capital markets as well as having greater options to manage their finances and secure their future.

3. It is, therefore, obvious that the capital markets today handle unimaginably large amounts of monies which flow from the smallest of investors to the largest of conglomerates in the form of capital and from the latter to the former in the form of return on their investment. Besides, the rapid increase in technology which has virtually dissolved the concept of time lag in transactions and exchange of information among the various players in the capital markets, coupled with social and cultural changes in the society, have encouraged the capital market intermediaries to bring out a number of innovative financial products that address the changing needs and risk appetites of the investors.

4. Money and information, thus, have a critical place in capital markets. If the amount of money circulating in the capital markets is a reflection of the depth; the credibility, timeliness and accessibility of the information available to the various market participants, including potential investors, indicate the maturity and strength of these markets. Reliable and timely information is therefore indispensable not only for decision making but is also the bedrock of fairness and transparency in the capital markets. The auditing profession plays significant role in providing such kind of assurance to all stakeholders.

5. The financial crises both in the distant past as well as in the not to distant past have amply brought to fore the fact that capital markets cannot operate in an atmosphere where equally reliable and timely information is not available to the various components and players in the market. Moreover, it has been observed that market players indulge in unhealthy unethical business practices for short term and personal gains, especially in terms of risk management, earnings management, remuneration practices, etc., at the cost of good governance and investor protection, which are the foundation stones of any capital market that is looking towards growth and sustainability. The observation made by Anton Valukkas in his March 2010 report on the examination of the Lehman Brothers only reiterates this when he says that,

   "Lehman's financial plight, and the consequences to Lehman's creditors and shareholders, was exacerbated by Lehman executives, whose conduct ranged from serious but non-culpable errors of business judgment to actionable balance sheet manipulation; by the investment bank business model, which rewarded excessive risk taking and leverage;………"

These unhealthy practices by the top management led to erosion of valuable capital from the market. Information technology that was instrumental in integrating the capital markets world over proved to be a spoil sport in the times of financial crisis. The damaging effects of crash in capital market in one part of the globe could not be contained and in no time, had a domino effect, bringing down the other capital markets too. These crashes resulted in a vicious downward economic spiral in many economies, leading to loss of jobs and a lifetime of savings and security for a large section of the public, at large. The more damaging and, perhaps, long term impact, however, was loss of credibility and trust of the common man in not only these markets, driving them away from these markets, but also the regulators and the auditors.

6. From the above, it is amply clear that fairness, transparency and credibility are the drivers of an efficient capital market. In fact they are the factors that build resilience in the capital markets. External auditors, in their various capacities, have a crucial role in ensuring that these drivers remain functional in spirit. The following paragraphs examine the various ways in which the external auditors play their part apart from stating certain developments which may have far reaching impact in the near future.

7. Financial statements are an important instrument of communication between the entity *vis a vis* the various internal and external stakeholders since the financial statements, and the annual report containing these financial statements, as they stand today, contain pertinent information about the operations of the entity. The financial statements are designed to provide a view of the state of affairs and financial performance of the entity during the period covered by the financial statements. The financial reporting frameworks lay down principles that ensure that this state of affairs and financial performance is fairly presented by the financial statements. These financial statements find acceptance among the stakeholders, especially, the external stakeholders such as the shareholders, financiers, analysts, regulators and public at large only if they are seen as being credible and reliable by them.

8. The onerous task of lending credibility to the financial statements prepared and presented by the management lies on the shoulders of independent audits. An independent audit is carried out by the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework. What enables an independent audit to lend credibility to the financial statements is the fact that it is carried out by an appropriately qualified professional, ie, a chartered accountant, who is bound by a Code of Ethics, containing stringent provisions for ensuring auditor's independence *vis a vis* management and ethical conduct by the former, and in accordance with the globally accepted performance and quality benchmarks.

9. Having realised the significance of the auditor's role in enhancing creditability of financial information, it is important for us to look at certain emerging developments across the world, namely, the likelihood of implementation of IFRS; the provision of assurance on governance; and the integrated reporting so as to add further value to auditor's opinion. With the advent of the International Financial Reporting Standards, the preparation and presentation of financial statements is likely to undergo significant changes. The most pertinent of these changes being the move to fair value accounting *vis a vis* historical cost. The basic idea behind introduction of the concept of fair value is to help the financial statements capture and reflect the fair value of the assets and liabilities as on the reporting date since the same may have undergone significant appreciation or depreciation subsequent to their acquisition. This appreciation or depreciation may have been on account of the factors within the control of the entity such as, quality of products/ services, efficiency or otherwise in use of resources that gets translated into rate of earnings, governance practices which create market perception as to the ethical conduct of business, etc. The factors beyond the control of the entity could include extent of political stability/ instability in the markets where the entity operates, technological changes, etc. Fair valuation of assets and liabilities thus provides information that is more contemporary, relevant and nearer to the reality for the users of the financial statements, something that the historical cost approach was found to have been lacking.

10. Substantial increase in the disclosures in the financial statements is another important change which may be brought about by the IFRSs. The increase in disclosures is indispensable given the move from historical cost to the fair value. The users of the financial statements need to be provided clear and comprehensive information relating to models, assumptions, etc., used by the management to reach the fair value of a particular asset or liability. Without such disclosures, the financial statements would once again lead to information asymmetry between preparers *vis a vis* users of financial statements.

11. Audit of fair value based financial statements and disclosures has been particularly challenging for the auditors. Strong knowledge of the client and its internal as well as external operating environment, especially, the industry have become a prerequisite for the auditors to be able to effectively audit the fair

value. Assessment of the integrity of the management has always been critical for the auditors in assessing the risk of material misstatements in the financial statements and accordingly planning and performing the audits. This aspect, however, seems to have gained more importance on account of increased risk of management bias in fair value accounting estimates. Audit of fair value estimates is fraught with other challenges too, particularly with regard to audit evidence, applying materiality judgments and evaluating misstatements. In its January 2011 Discussion Paper titled, *The Evolving Nature of Financial Reporting: Disclosure and Its Audit Implications*, the International Auditing and Assurance Standards Board has raised certain very pertinent issues in respect of audit of fair value related disclosures.

12. The Discussion Paper could not have been more correct when it observes that "where there are materially different approaches to determining accounting estimates for similar items, a narrative disclosure of the approach adopted is likely to be necessary, given the importance of the underlying judgements. Such diversity should trigger auditors to apply greater scepticism and to challenge management's judgements about modelling approaches and inputs. Given their corporate access to the approaches to valuations undertaken by their portfolio of clients, auditors may be in a good position to challenge their client on whether their judgements are appropriate and their disclosures adequate." Professional scepticism therefore will help auditors to better recognise substance over form of the transactions and to extract more value from the audits.

13. The governance practices adopted by the capital market players are the cornerstone for ethical business practices in their functioning *vis a vis* the third parties. They play a critical role in ensuring fairness and transparency in the capital markets. Sir Christopher Hogg, former Chairman of the Financial Reporting Council, UK once observed that, "The financial crisis is the result of a massive failure of governance at every level". In fact, an observation which impels us to think beyond as to role of other agents, like directors, particularly independent directors, regulators in the growth of healthy capital markets.

14. In addition to independent audit of the financial statements, assurance on corporate governance practices at the client have thus emerged as an important area where the regulators see a value add and contributory role to be played by the independent auditors. A number of securities regulators world over have already prescribed detailed corporate governance requirements for the listed entities with requirements for the same to be reported upon by the entities' independent auditors.

    For instance, clause 4a requirements laid down by SEBI for listed entities have considerably enhanced the information disclosure requirements. Particularly, clause on internal control over financial reporting by the independent auditors is noteworthy amongst others.

15. Connected to good governance practices is the fast emerging concept of integrated reporting. The various stakeholders are increasingly feeling that the financial statements by themselves are unable to provide a holistic and comprehensive perspective of the operating environment, especially, external variables such as social, economic, environmental, political factors, and how they can significantly impact the future of the organisation. An integrated report would, normally, include information on aspects such as the organisational overview, business model, governance structure, operating environment, strategic objectives, competencies, Key Performance Indicators, Key Risk Indicators, an account of organisational performance, future performance objectives, remuneration policies and analyses of these elements.[3] An integrated report is therefore a much value add document for the stakeholders looking in terms of sustainability of the organisation as it provides an integrated perspective on the risks and opportunities facing the entity. The users of the integrated report can therefore make an informed assessment of whether the actions and plans of the management are realistic and good enough to face those risks and make the maximum utilisation of the opportunities. Many nations are, therefore, actively working on developing framework for integrated reporting.

16. Capital markets, world over, operate under a strict regulatory regime and understandably so, given the amount of public monies involved, their reach in terms of number of investors and geographical spread and importantly, the interdependence among the global capital markets. While the regulators keep a close watch on and have a their own mechanisms to collect information from the market players in the form of periodic returns and filings, they need to be ably supported in their endeavour by other components of the capital markets such as the auditors. The independent auditors, given their position and access to information relating to the entity's operations, especially, financial matters, play a significant role in helping the regulators in effective and prudent supervision. In fact in their June 2010 Discussion Paper, *Enhancing the Auditor's Contribution to Prudential Regulation*, the Financial Services Authority and the Financial Reporting Council, UK have identified increased frequency and earlier timings

of meetings with the auditors as well as enhanced information sharing with the auditors as two ways by which the auditors can be engage to positively contribute to supervisory and regulatory efforts.

17. Having meetings with the auditors handling audits of bigger market players before the audits are completed or are nearly complete would help the regulators and supervisors to identify issues well in time and nip the problem in the bud. The significant accounting policies adopted by the managements, especially in the areas where accounting standards are yet to be issued, methodologies and assumptions underlying the key accounting estimates, particularly, the fair value accounting estimates could, among other matters, could be subject matter of discussion at these meetings. The idea of having such meetings would, however, require legislative changes in a number of jurisdictions to overcome client confidentiality requirements binding the auditors. Besides, willingness to share information and bridging the other communication gaps between the regulators and the auditors would play a defining role in success of such endeavours. Cost would be another factor to be considered in the context of such meetings.

18. To summarise, fairness, transparency and resilience at the most grassroots level in the capital markets is the need of the hour. The auditors given their unique position in the system, can play a critical role in meeting these needs. A number of initiatives are already underway to rethink the audit reporting model that can satiate the information needs of various stakeholders. Whereas the success of the auditing profession in its endeavours would hinge on its five quintessential, i.e., independence, integrity, professional scepticism, judgment and knowledge of the client, it is only by putting the public interest at the forefront that the profession can continue to think and act rationally and justify its existence to the society.

Disclaimer

Views expressed in the article herein are those of the author and do not necessarily reflect those of ICAI.

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[1] *Examining the Main Street Benefits of Our Modern Financial Markets*, Charles M Jones and Eric R Sirri.

[2] *The Role of Capital Markets in Economic Growth*, The Catalyst Institute.

[3] *Framework for Integrated Reporting and the Integrated Report – A Discussion Paper*, January 2011, the Integrated Reporting Committee, South Africa.