Auditors : Harbingers of Investors' Confidence

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Today the Indian Corporate Sector is characterized by more than 75,000 Public Limited companies out of which 7,000 are listed on the Stock Exchange having an aggregate Market capitalisation of about Rs. 1,40,000 crores. The fabulous growth of the Indian Corporate sector spanning over last six decades since independence is primarily attributable to the availability of reliable information to investors for their investment decision making process. It is imminent that financial information available to investors in the Capital Market should not only be reliable but also depict the economic affairs of the company in a faithful manner. Access to capital markets, mergers, acquisitions, and investments in any entity depend not only on the information that management provides in financial statements, but also on the assurance that the financial statements are free of material misstatements. This assurance is provided, to a considerable extent, by an audit. An audit provides users with a reasonable assurance that an entity's financial statements give a true and fair view in conformity with the applicable financial reporting framework. In plain and simple terms, an audit enhances investor's confidence that financial statements do not contain material misstatement(s) (on account of a fraud or an error). The assurance is there because financial statements have been examined by a person (the auditor) who is an independent and objective expert. He is also knowledgeable about the entity's business and the applicable financial reporting requirements. In other words, an auditor's opinion provides an assurance that the financial statements have been prepared and presented fairly.

An auditor follows a process involving testing of internal controls followed by examination of the data underlying the entity's financial statements to obtain sufficient appropriate audit evidence which, along with his other procedures, provides the basis for the auditor's opinion about whether the financial statements are free of material misstatement. In an audit of financial statements, the auditor forms an overall conclusion about whether:

- the financial information has been prepared using appropriate accounting standards, which have been consistently applied;
- the financial information complies with relevant statutes or laws;
- the view presented by the financial information as a whole is consistent with the auditor's knowledge of the business of the entity; and
- there is adequate disclosure of all material matters relevant to the proper presentation of the financial information.

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 use of judgements and estimates in financial statements (that is, financial statements also contain approximations, not merely exact amounts with respect to many items especially depreciation, provision for bad and doubtful assets, etc.);
- inherent limitations of any internal control system in an entity;
- the use of testing by auditor; and
- most of the evidence available to the auditor is persuasive, rather than conclusive, in nature. For example, the external confirmations from a debtor as to the amount owed by him to the auditee is only a persuasive evidence of the existence and realisability of the debtor but is not a guarantee therefore. A future turn of events may make that debt as unrecoverable for the auditee.

The Auditors, with a view to maintain the high quality of audit, perform their work within the framework of Engagement and Quality Control Standard issued by the Institute of Chartered Accountants of India. The Engagement Standards comprise of the following four categories:

- **Standards on Auditing (SAs),** to be applied in the audit of historical financial information.
- **Standards on Review Engagements (SREs),** to be applied in the review of historical financial information.
- **Standards on Assurance Engagements (SAEs),** to be applied in assurance engagements, dealing with subject matters other than historical financial information.
- **Standards on Related Services (SRSs),** to be applied to engagements involving application of agreed-upon procedures to information, compilation engagements, and other related services engagements, as may be specified by the ICAI.

Standards on Quality Control (SQCs), issued by the Institute, are to be applied for all services covered by the

Engagement Standards. These Standards codify the best practices in the respective area of auditing. The Standards are developed by the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India and are issued under the authority of the Council of the Institute. It is the duty of the Members of the Institute to ensure that these Standards are complied with in an audit of financial statements covered by their audit report. If, for any reason, the member has not been able to perform an audit in accordance with the Standard, his report should draw attention to material departures therefrom. Till date, the Institute has issued thirty seven Engagement Standards.

As far as scope of duties and responsibilities of Indian auditors is concerned, the Government of India, while amending the legislation, namely, the Companies Act, 1956, has always reposed more confidence in the Indian chartered accountants. Section 227 of the Companies Act, 1956 was amended through insertion of sub-section 1(A) in 1965 and further the issuance of the Manufacturing and other Companies Auditors' Report Order, 1975 (MAOCARO) in consultation with the Institute under section 227 (4)(A) of the Companies Act, 1956. The issuance of the 1975 Order heralded a new era as far as scope of duties and responsibilities of auditors is concerned and at that point of time, it was popularly known as the "Social Audit Order" indicating the nature of duties which an auditor was expected to discharge while expressing opinion on financial statements. The MAOCARO, 1975 was substituted by the Companies Auditor's Report Order, 2003. What is noteworthy is that with the insertion of sub-sections (1A) and (4A) in Section 227 of the Companies Act, 1956, the scope of the duties of an auditor has enhanced substantially, since various clauses deal with propriety aspects. The issuance of the CARO, 2003 (earlier known as MAOCARO) was a significant step to bridge the expectation gap between the society and accountancy profession. Particularly clauses relating to depositing undisputed statutory dues, default in repayment of dues to financial institutions or bank or debenture holders; guarantee given for loans taken by others or bank or financial institutions as also the terms and conditions are prejudicial to the interests of the company; term loans applied for the purpose for which they were obtained; whether funds raised on short-term basis have been used for long-term investments; whether management has disclosed on the unused money raised by the public issue; whether any fraud by the company has been noticed or reported during the year, etc. are some of the instances which indicate the enhanced scope of duties and responsibilities of the auditor. Such an additional reporting requirements cast upon the Indian auditors are perhaps unparallel as far as reporting requirements in other parts of the world are concerned. This also reflects the faith of the government in the Indian accounting profession in response to the changing objective of the stakeholders.

It is important to appreciate that the Auditor expresses opinion on the companies financial statement as a whole. In this context their main focus is reporting on the risk of material mis-statement in the financial statements which is nothing but the financial reporting risk. It is quite significant to distinguish between financial reporting risk and another risk such as business and operational risk which in turn may have implications for investment decisions. While performing audits, the Auditors take into account the pervasive existence of risks other than financial reporting risk. However, the Auditor's procedures are not designed to analyse the effectiveness or the efficiency with which the company conducts its business.

At this stage, it is significant to appreciate that auditor's liability to third parties is governed by Hedley Byrne & Co. Ltd. V. Heller & Partners Ltd. (1963). This arises out of agency relationship wherein though investors are ultimate beneficiaries of the audit but they do not have direct relationship with the auditor. Based on the assurance given by the auditor about the reliability of financial information, the investors take decisions to hold or sell shares. The said principles of duty and care have been reviewed in many cases and more significantly in the case of CAPARO industries V. Touche Ross, the House of Lords observed that the auditors owed no duty of care to the members of the public who relied on the accounts in deciding to buy shares. It was difficult to visualize a situation in which individual shareholders could claim to have sustained loss in respect of existing shareholdings referable to auditors' negligence which could not be recouped by the company. A purchaser of additional shares stood in the public to whom the auditors owed no duty. It was also held that the purpose of the auditor's certificate was to provide those entitled to the report with information to enable them to exercise their proprietary powers. It was not for individual speculation with a view to profit. The purpose of annual accounts so far as members are concerned, was to enable them to question past management, to exercise voting rights and to influence future policy management.

The learned judges observed that for a duty to exist the following conditions must be satisfied:

(i) the dependent would need to be fully aware of the nature of the transaction the plaintiff had in mind;

(ii) he must know that his advice or information would be directly or indirectly communicated to the plaintiff; and

(iii) he must know that the plaintiff was likely to rely on the advice or information in deciding on the transaction that he had in mind.

Over last six decades there might have been few major corporate frauds, to name, Dalmia Jain Group of Companies in early 50's and Satyam in early 21st century but these are mere aberrations from which lessons have to be learnt. We at the Institute have always been conscious of such developments and have been taking

multitude steps so as to bring further improvements in the existing procedures and processes. The establishment of Financial Reporting Review Board and the Peer Review Board, combined with continuous review of Auditing Standards and issuance of Technical Guides and Statements on contentious matters are steps intended to enhance the performance of the Indian auditors. In the given scenario, it would not be far-fetched to say the auditors are true harbingers of Investors' confidence.