Role of auditors in promoting investor confidence

Jamil Khatri
Partner
BSR & Co.LLP

Overview

High-quality financial reporting and a robust auditing profession are the bedrock of market capitalism. Investors and other stakeholders use information in the audited financial statements as they seek to assess a company's performance and its prospects. While the primary responsibility for the financial statements lies with the management (under the supervision of the audit committee), auditors play a crucial role in providing credibility to the financial statements by auditing them independently. Through this independent challenge, auditors seek to provide an assurance that the financial statements are free from material misstatements.

Being responsible for financial performance, management may have incentives to misreport. Further, misreporting may occur due to errors in the financial reporting process. These risks have been accentuated as businesses become larger and more complex, and as the economic environment becomes more difficult and uncertain. An independent challenge by the auditor is an important safeguard against such misreporting.

How can auditors enhance confidence?

There are four areas through which auditors can enhance confidence in the audit. This may require changes both in terms of processes as well as the culture within the audit profession.

- **Independence** - The objective of providing credibility to the financial statements cannot be met if investors believe that there is a lack of independence on the part of the auditor while providing their opinion. Auditors need to be independent both in form and in perception. Independence also requires that auditors acknowledge and demonstrate that they are responsible primarily to stakeholders such as investors, lenders and other users of the financial statements who rely on their audits.
- **Professional skepticism and a culture of challenge** -Auditors need to demonstrate a high degree of professional skepticism, particularly in areas involving management judgement and assumptions, and in areas that are susceptible to fraudulent reporting. The readiness to challenge and ask probing questions about a company's transactions, processes, controls, reporting and governance practices would greatly add to the quality of audits.
- **Consistent high-quality audits** – This would require that the auditor is geared to ensure consistent compliance with the auditing standards by investing in people, processes and technology. In the area of people, auditors need to attract and retain talent and ensure that they are adequately trained. Process investments would entail development of appropriate tools and quality control checks that can be used by the audit field teams. Finally, without an appropriate investment in technology and data analytics tool, auditors may not be able to obtain and provide the required level of assurance in a technology-dependent world.
- **Clear and transparent reporting** – the audit report serves as the mode of communication between an auditor and the users of the financial statements. While the format of the audit report is generally prescribed by regulations, auditors have the flexibility to describe key audit areas that they focused on and the procedures performed in these areas, through their 'key audit matter' reporting. Further, auditors need to ensure that they call out any disagreements or concerns by appropriately modifying their audit reports either through qualifications or highlighting any going concern uncertainties in a timely manner. Similarly, auditors should ensure that matters that are fundamental to users' understanding of the financial statements are highlighted through emphasis of matter reporting in their audit reports.

What support do auditors need in this journey?

While auditors need to play their part in enhancing confidence in the financial reporting process, a high-quality financial reporting and audit environment would need active support from several other stakeholders:

- **Audit Committees** – Given their oversight of the financial reporting and audit process, audit committees can support the high-quality audit agenda by ensuring that they objectively evaluate issues raised by the auditors; understanding any information flow or other challenges faced by the auditor; and ensuring that the audit fees are at fair levels.
- **Regulators** – Regulators need to ensure transparent and well-defined processes to review the work done by auditors. This needs to be achieved in a balanced and constructive manner keeping in mind the objective of continuous improvement in audit quality. Further, regulators need to ensure that all stakeholders such as management and audit committees fulfil their responsibilities such that high-quality financial

reporting is a collective responsibility.

- **Investors and other users of the financial statements** – Users may need to better understand the scope of a statutory audit, which would enable them to determine what to expect from the audit. Similarly, investors and other users should proactively provide inputs to companies and regulators on their expectations such that any additional areas where they may need assurance (for example risk factors, non-GAAP measures, Environmental, Social and Governance factors) can be covered either voluntarily by companies, or by regulators as they consider future changes to the scope of work done by an auditor.

Conclusion

High-quality financial reporting, strong internal controls and a robust audit, are the collective responsibility of all stakeholders in the ecosystem. Management, audit committees, regulators and auditors, all need to work together in this area. While auditors certainly need to play their part, the best results will be achieved when all the players in the ecosystem work towards this objective. The United States is a good example where greater responsibilities on management, audit committees and auditors; coupled with strong oversight by regulators; has been viewed to improve the overall quality of financial reporting, internal controls and audit – thereby improving overall investor confidence.

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