Accounting and Auditing Standards - Introspection

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The preparation and presentation of the financial statements are very important for understanding the results of any business activity for a given period. These are also relevant for the Government and various regulatory agencies to review that proper taxes are paid by the business undertaking. The proper understanding and implementation of accounting standards are extremely important to ensure that the financial statements are properly prepared. Similarly, when the auditors undertake statutory audit of the financial statements and certify that they give a true and fair view of the financial position and performance of business enterprise, it is a positive assertion to the shareholders. The auditing standards provide the basis on which the auditors undertake the audit and give their report. Thus the accounting and auditing standards are the basis on which the credibility of financial statements is established.

It would be useful to review the evolution of these standards and also to carry out introspection to decide their relevance and utility in the current situation.

When we look at the evolution of standards, broadly, there are three types of standards which the accounting profession should look at - accounting standards, auditing standards, and the quality control standards, which are considered as a part of auditing standards. There used to be national standards, international accounting standards, and US-GAAP in the past. Over a period of time, it was found that the international standards and US-GAAP were going in different directions. So, it was felt appropriate to start with International Financial Reporting Standards (IFRS). Every country in the world which has got its own regulatory body in Accounting or Auditing would normally evolve its own standards, like we have done in India. These were the accounting standards, and the auditing standards.

In India, it is the Institute of Chartered Accountants of India (ICAI) which was the standard setting body and the Companies Act adopted those standards, initially through NACAS (National Advisory Committee on Accounting Standards) and now NFRA (National Financial Reporting Authority). Now NFRA has the authority to formulate the standards, but the basic standards come from the ICAI. ICAI is a member of the international bodies, and therefore, by and large, we adopt the international standards. As a country, long time back, we decided to adopt IFRS, but with suitable modifications. So, most of the IFRS have been adopted, converged into India, which are now called IND-AS, making them suitable to the local needs of the legal requirements.

The Accounting Standards and the auditing standards have become a part of the Companies Act; While the standards are set, the drafts are issued, various components of the society give their response, those responses are considered, and then it becomes a standard, which is final. It is sent to the specific bodies, like NACAS earlier, now NFRA, and they will issue the standards. This is how these standards are evolved.

Ethics and Accounting Standards

By and large, all accounting professionals carry a paper for their examination called ethics & value system. It is very nice to have such a paper, but one must consider it appropriate to have the ethics & value system in accounting itself. When we look at the accounting standard, there are two ways in which people analyze the standard.

People find out what is allowed by the accounting standard, and people also find out what is strictly prohibited by the accounting standards. So something which is allowed and something which is prohibited is very clearly known. But there are a few other people who try and find out what is not specifically prohibited by the accounting standard, and that is what gives birth to what is known as “creative accounting”. I think it is the creative accounting which is the first cause of trouble for the accountancy profession in the world at large. When more and more creative accounting comes in, then it gives rise to problems in the future. This is one area which entire accounting profession will have to be very careful about.

Off Balance Sheet items

When we look at the balance sheets, today there are various items which are on the balance sheet. However items like derivatives, embedded derivatives, commitments, right to agree to sell, right not to agree to sell, right to dispose of and many other kinds of rights and obligations do not necessarily get converted into financial terms and therefore do not get reflected in the financial statements. Such type of rights and obligations. would be the issues that one needs to look at. These could have major implications on the business and therefore need to be evaluated properly.

Ownership of Standards

The sense of ownership about the standard is a major issue. Today, it appears that the Auditors are expected to own the standards. Actually, it is the Industry which has to own the accounting standards, otherwise, it becomes the job of the audit profession across the world to ensure that the standards are complied with. The management has to ensure that the standards are actually implemented while preparing financial statements and the audit profession has to see that they are actually implemented by doing the audit in accordance with the auditing standards. So, the sense of ownership of the standard in India and across the world is very important. We will have to make efforts to ensure that the industry bodies start owning those standards. Unless this happens, there are going to be troubles in the future.

Constant Changes in Standards

We find that there are constant changes in the accounting standards. Such changes arise on account of the changes made in IFRS which are then incorporated in India in IndAS. One should welcome such improvements which take place in accounting standards. But, constant changes in accounting standards practically every year, makes some people to believe that we are changing the goal post.

Accounting standards lay down principles which takes time for the management, the accountants and the auditors to understand, implement and practice. For the society to understand the importance and implications of such standards it takes a longer time. So there is a need for all of us to keep in mind that we may have to keep the standards constant for a period of two or three years and then make changes at the appropriate time. The stability in the standards will increase the belief in accounting standards in a much better way.

Accounting & Business Objectives – The Interplay

The purposes and objectives of accounting are different and the business objectives are different. Accounting measures the results of the business operations as they are communicated to the shareholders. And therefore, whenever people try and connect the business objectives with the accounting standards, there are bound to be different perceptions. It has to be clearly understood that accounting is only a unit of measurement to understand, evaluate, record and disclose the results of the businesses as carried out by the business people.

Auditing Standards

When we look at the auditing standards things are slightly different. The measurement of implementation of auditing standard is quite difficult. In accounting, at least one can look at the disclosure results and find out whether what is done is right or not. But in auditing, the ultimate result is an audit report, which normally is a standard report. So, by itself, whether standards have been implemented in reality or not is a question mark and that really is the challenge before the audit profession. This is where the documentation becomes important.

Documentation

The performance evaluation of auditors is certainly a difficult task and everybody likes to comment on that. The most important thing is the service quality in the implementation of audit standards and that would depend upon competence coupled with character. Competence alone is not sufficient unless the character is evident to support the competence. In this respect, documentation becomes very important.

Dealing with failures

Generally, as an accounting profession, whenever there are major failures world over or in our country, there is a big noise about standards not being sufficient. What we need to learn is how to deal with failures. Whenever there is a commercial failure, one must find out whether it was a failure of an accounting or auditing standard or was it a failure of an individual person, individual firm or a group of firms?

If we notice that the standards were appropriate, but it was a failure of the individual or firm, then one need not talk about changes in accounting standards or the legal requirements. However over a period of time, all of us have been used to changes in laws whenever there is a major failure. This is a knee-jerk reaction because if the standards were not up to the mark, by now, the standards would have been substantially changed. Whereas you will find that, actually the standards more or less have remained same for a long period.

The audit profession, world over should be able to distinguish between failure of a standard and failure of the actual implementer of the standard.

Expectations Gap:

There are 2 types of expectation gaps. One type of gap is what the society expects and what the audit profession promises. The other type of gap is between what the audit profession promises through the promulgation of auditing standards and what the audit profession actually performs. The second expectation gap is dangerous because what the audit profession promises is given by the standards and when compared to actual performance, if there is a gap, the auditors need to improve upon that. However what the society expects and what the audit profession promises, if there are gaps in these two items, then all over the world various accounting bodies must come forward to meet that gap effectively. We must start educating the society on this aspect. The most common example is the fraud detection.

Whether detection of fraud is the job of an auditor and can he do it in the course of statutory audit that is done on a quarterly basis, annual basis, etc. is an area on which research would be more useful, especially to see if this was the objective of the auditing standards. Therefore, what effective steps will have to be taken by the auditors in changing the standards? How much time it will take for auditors to detect the fraud every time? And can they really do that? This will naturally have the implications on cost of conducting such audit. This is a serious problem area for the profession at large in future.

Society Expectations

The Society expects the business entities to exhibit true and fair view of its financial position and performance through its financial statements. The Society also expects the auditors to perform their job in accordance with the auditing standards. As long as both these parties are performing their job diligently and consciously, the faith in the audit profession will continue to be high. However, such confidence gets shaken up whenever there are major business failures. The auditors are expected to play a major role in reporting the wrongdoings of the business entities through their audit report. In case, the auditors do not perform their job properly, the Society may seek alternate solutions.

Standards for Small Entities

It is useful to review the existing accounting standards to see whether the rigour and expectations of disclosures are relevant for small entities. Proper modifications in these standards for small entities may be useful to them for effective implementation.

Quality Control Standards:

The Quality Control Standards lay down the basic rules and procedures that a professional auditor should follow while conducting the audit. These Standards are therefore very important for the organisation and management of the office of a professional auditor, These Standards lay down various requirements which are very essential for all audit firms. However, it may be useful to review these standards and decide whether the rigours laid down in these Standards are equally relevant even for firms who undertake audits of small size entities. This might ensure that the firms would actually implement what is laid down in the Quality Control Standards.

Conclusion

There is a need for the researchers and the relevant authorities to study various aspects mentioned above and ensure that the accounting and auditing standards retain their relevance and play an important role in Good Corporate Governance.