The Value Of Audit & Business Confidence

By Suren Rajakarier

The audit industry is one of many elements of assurance in a complex defense line against corporate misreporting or frauds. The many gatekeepers, such as the SEC, CSE, the rating agencies, audit committees, internal audit and prudential regulators must consider the scope of their responsibilities and be connected to the audit process. If the global financial crisis has taught us anything it is that there remains a pressing need for more assurance and not less. Too much narrow focus on the financial statements, which by their very nature can only look to the past, is no longer considered sufficient by many.

As it currently stands, the function of the audit is to;

* ensure that a company complies with applicable accounting and relevant regulations;
* question companies' internal control processes and financial reporting systems;
* make the company aware of the financial reporting risks to which the company is exposed;
* improve companies' financial reporting and disclosure decisions;
* provide a disincentive to commission of fraud by managers and employees;
* improve access to capital and lowering companies' cost of capital by opining that company's results and related disclosures are fairly presented

This remains extremely valuable to investors.

But, how many audit committees or directors allow the auditor to contribute to the business? When the auditor identifies potential financial reporting risks or weaknesses in the internal control systems the audit committees and management

refuse to accept the insight, often referring to the findings as irrelevant or immaterial. However, when significant frauds or errors are uncovered in the same areas, then they are the first to ask “what did the auditor do?” They downplay their role in management and use the auditor as a scapegoat to cover mismanagement or misreporting. Is rotation of auditor the answer? May be the subject of a university research project could be – the benefits of rotating the auditors without any change in the mind set of the Board of directors/ Audit committee.

Let me briefly counter the mandatory audit firm rotation argument. It does not take away the temptation to keep clients for the entire pre-established rotation period. If a difference of opinion occurs in any but the final year before rotation, there is the potential for losing the client “prematurely.” Any auditor with a short-term emphasis might be under even greater pressure to avoid losing the client. Thus, even with firm rotation, both a conscious and a subconscious desire to please the client during the rotation period can affect the audit process. Such short term thinking would affect business confidence and the value of audit negatively. Several countries have adopted and subsequently dropped mandator y audit firm rotation because it did not achieve public policy goals. In Italy, the Bocconi University Report concluded that audit firm rotation, which is mandatory in Italy, is detrimental to audit quality but does seem to have a positive effect on improving public confidence in the corporate sector. Despite the benefits of rotation being far from certain, it appeals superficially to many!

If You Are Expecting Your Auditor To Respond To The Challenges And Help In Your Business And Add Value Through The Process, Then Brace Yourself To Be Transparent, Ready To Listen And Draw From The Auditor’s Experience

If you are expecting your auditor to respond to the challenges and help in your business and add value through the process, then brace yourself to be transparent, ready to listen and draw from the auditor’s experience. Discuss issues proactively and work out solutions in accordance with the laws and regulations. Don’t try to out think the auditor. It is not a game of cat and mouse! On the other hand, the events of the last few years have all produced examples of companies that have collapsed after receiving apparently ‘clean’ audit reports. In consequence, the audit profession has been placed on the defensive at various points; painstakingly seeking to point out that an audit is not a guarantee either against fraud or of future

business success. If so, some may ask “why audit?” and I would like to ask, why health checks?, why security guards for your buildings?, why service your vehicle regularly?, why visit your dentist every 6-12 months? and many more “whys” to a ridiculous level! Because you wouldn’t find out what was prevented or avoided, you only get to know the exceptions. Is prevention better than cure?

Auditors are only too aware that the assurance needs of modern global markets outstrip the parameters of the audit in its current form. Today, large companies have sophisticated IT systems that drive knowledge and collect information all year round. Issues and discrepancies are flagged along the way, and easy to hide in a paper-less environment. The time frame between reaching and confirming the numbers has also been significantly reduced. For this to be achieved management has to be proactively involved in the audit process. The audit committee can help by serving as a mediator in financial reporting disagreements between the auditor and management. Indeed, research in developed markets has found a direct relationship between the strength of company corporate governance (the audit committee) and the quality of its financial reporting. But in the local context, professional bodies and regulators will have to insist that audit committees perform a significant task in financial reporting rather than ‘rubber stamp’ the financials to fulfill a requirement.

In conclusion…

“There comes a time when one must take a position that is neither safe, nor political, but because one’s conscience tells one that it’s right”… Martin Luther King.

Audit committees can play a very important role in enhancing auditor independence and audit quality. For example, if audit committees are actively involved in helping to ensure auditor independence and audit quality, many of the perceived benefits of audit firm rotation could be realised at the initiative of the audit committee, by using the existing auditor.

While in good economic times failures by management and auditors get hidden, they surface during bad times to haunt you. Clearly there would be much to debate

and agree upon if auditors were to broaden their role. Any discussion around increasing the scope of audit has to be thought through in terms of liability (risk) and fees (rewards). Funnily enough, audit fees is one of those actively negotiated payment for professional services compared to doctors, lawyers, architects, consultants and other older professions! The audit firms also have to take the blame for this situation of 'digging their own grave' when companies take advantage of the "cut-throat disease". There are instances where for governance purposes the company proposed to rotate the auditor, however, when the existing auditor reduced the fees significantly, governance and independence was achieved by re-appointing the same auditor!!

Finally, audit is used by all businesses to instill and maintain confidence and trust among their many stakeholders. However, the value of the skills of auditors is not promoted and defended against perceptions that the audit represents unnecessary 'red tape' by those responsible for the profession. May be immediate action is required to consistently promote the value of audit, independence and quality without letting people take advantage of the so called governance rules to achieve personal goals. This is the foundation of the profession and its national body, the Institute of Chartered Accountants, not the building!

Investors, the finance profession and the general public must unite to uphold and promote the value of audit to increase business confidence and to facilitate growth of the capital market in Sri Lanka in the post conflict era if we are to realise the dreams set by our leaders for 2016.

Writer: Suren Rajakarier, Partner and the Head of Audit at KPMG in Sri Lanka and the Head of Financial Services for KPMG in the Middle East & Sothern Asian Region.