Understanding Value Of Audit To Enhance Capital Market Credibility

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Every Director who takes up the position in public interest entities should be made to understand the following. After every collapse of a large company, the debate on audit quality springs up. Some ask, ”If audits were really worth anything?” After all, the big financial companies that are in trouble all have “clean” audits. So what’s an audit really worth – to understand the reality, one needs to answer the following question, honestly. “We take our cars for a service two or three times a year, yet one day it meets with an accident, due to a brake failure or drunken driving or due to another vehicle which was driven negligently. Therefore, what was the point in taking the car to a service centre, regularly?”

By Suren Rajakarier

However, Directors who are sensitive about their fiduciary duty accept that the statutory audit enhances integrity and credibility of the financial statements; the sharing of best practices by the auditor helps to improve the financial reporting process and strengthen the system of internal control. Additionally, when the management and the finance team know about an impending audit they make every effort to clean up to ‘put the house in order’.

To appreciate the value of audit, first, you have to understand what an audit is, and what it isn’t. An audited financial statement contains standard financial information, supplemental footnotes, and the all-important opinion letter. The letter expresses an independent opinion on the completeness and accuracy of the financial information up to a certain date in point, to the existing shareholders. The opinion is not an assessment of the financial condition or future prospects of the organisation.

Audits can also be described as a health screening exercise, a good bill of health means a lot to a health conscious person as opposed to a gambler. To independent directors, value is derived as a sort of an insurance policy. An insurance policy is taken not because you want to deliberately meet with an accident, but for protection. Audit is performed on historical information. That does not mean that the Directors also keep looking at history for their strategy. You don’t drive your car looking in the mirror all the time. You drive your car as a business owner looking forward. The external auditors will verify what has happened in the past and help you look ahead; see the roadblocks in front, so that you may choose to avoid them.

To explain what an audit isn’t, I need to continue with my analogy of a car. When a car is put for a service, the service centre will not replace the brake pads – because they’re wasted, the service centre will not force you to change your tires because they’re bald, the service centre will not confiscate liquor from your vehicle because you may consume while driving, nor will they overhaul the engine because it’s inefficient? However, they may comment about some of the issues in good faith, but that was not their job (scope). Similarly, the auditor works within a defined scope and follows defined standards.

This raises the question, what does the auditor do in the process of conducting an audit? The financial information provided by the organisation is scrutinised and verified. Verification relies heavily on the auditor’s ability to determine the value of the assets and liabilities. They should not verify values based on cash transactions but they should be fair values, which are based on market values. What about assets that don’t have a simple or ready market? This includes assets like privately held companies, real estate projects, and investments in plantations. The auditor can use whatever information sources that are available for this purpose, using a lot of judgment and estimates – it’s not absolute. They also verify transactions during a whole year in a very short period using samples. Whilst going through this process the auditor identifies weaknesses in the systems and potential risks that may affect the company in the future, and communicates them to management. Therefore, audits are valuable, provided the Directors are aware of the limitations and use them with caution.

Therefore, by submitting to a statutory audit, companies can identify potential procedural weaknesses based on comments made by the auditor and make changes prior to suffering financial difficulty or organisational failure. This is crucial in order to maintain public and stakeholder confidence in the business as well as enabling the business to operate with minimal losses. This process is entirely within the control of the Board of Directors. They can act on the comments or ignore them. By identifying potential risk and procedural deficiencies before they cause damage to the functioning of the business, organisations can reduce risk, cut costs, increase efficiency and maximise revenue thus safeguarding their future. This can be considered a byproduct of the statutory audit.

The fact that there are collapses and frauds does not mean that all companies in the world have collapsed. The negative publicity on auditors does not bring to light the amount of disasters that have been prevented due to value addition by auditors. Sensibly, one needs to think that there are a lot of other companies, which are doing well compared to the companies which have failed.

However, compensation commensurating to the work done by auditors is also a cause to the problem. Consider the case of MF Global, where in 2007, one of the company executives paid a combined USD 77 million to settle allegations of mishandling hedge-fund clients' accounts, as well as supervisory and record-keeping violations. In 2009, the company was fined USD 10 million for four instances of risk-supervision failures, including one that resulted in USD 141 million of trading losses on wheat futures. This means the risk within the company was increasing and probably required more attention by auditors. However, the fees paid to auditors reduced from USD 17 million a couple of years earlier to USD 10.9 million in 2011. This company filed for bankruptcy in 2011. The audit committee did not understand the risks involved and were unable to get the best effort from the auditor. They were busy squeezing the auditors to lower their fees. This is a case of "operation successful patient dead" story.

Quality Has Become The Casualty In The Audit Price War. Those Who Demand 'Value' Should Also Understand That 'You Get What You Pay For'

It is vital that the Board and the Audit Committee spend more time knowing the company's business operations. They also need to understand how an auditor forms his opinion and the complexities involved. If they don't know, how are they going to be effective in maximising the auditors' usefulness to the organisation? In the name of governance and independence, Boards have forced audit companies into a price war. However, quality has become the casualty in the audit price war. Those who demand ‘Value’ should also understand that ‘You get what you pay for’. If you are going to squeeze the audit firms further, you are going to get shoddy audits because there is simply not enough time for that auditor to spend. He will reduce time by looking at the overview, too busy and too concerned with getting into the details… It comes down to making sure you select the right auditor at the right price, which allows them to do the right job. The value created by AUDIT should result in the following benefits in a matured economy with good regulations and monitoring systems. Companies presenting audited financial statements would; improve access to capital and lower cost of capital, have better forecast of earnings by investment advisors and have a positive effect on corporate ratings by rating agencies, reduce risks identified during the audit to protect future profits and address inefficiencies identified during an audit to maximise profits.

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