New Auditors' Reporting Requirement—Safeguarding Public Interest

Instances of rising bad loans, insolvency, mushrooming of shell companies and a major fraud in one of the largest PSU banks have further accentuated the debate on the expectation gap from the audit profession. Auditors are being blamed for not detecting the fraud. Their intention is being questioned. Consequently, the Government recently notified Section 132 of the Companies Act, 2013 to set up the National Financial Reporting Authority, an independent regulator to oversee and regulate the audit profession. Though, only time can justify this step if this would help the audit profession. The author duo in their article discuss the expectation gap and the changing role of auditors. Inspecting the international scenario, they touch upon many issues relevant for auditors and end up throwing the issues in open before the readers. Read on…

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Ralph Waldo Emerson: *Plato says that the punishment which the wise suffer who refuse to take part in the government, is, to live under the government of worse men; and the like regret is suggested to all the auditors, as the penalty of abstaining to speak,--that they shall hear worse orators than themselves.*

Latest Trend in India/Expectation Gap

Events in the last few months arising out of reasons like rising bad loans, insolvency, mushrooming of shell companies and a major fraud in one of the largest PSU banks have further accentuated the debate on the expectation gap from the audit profession. Auditors are being blamed for not detecting frauds. It is also being asked whether the auditors are really acting in public interest. As a fallout of these events and ignoring any facts to the contrary, the Government recently notified Section 132 of the Companies Act, 2013 ("the Act") to set up the National Financial Reporting Authority (NFRA), an independent regulator to oversee and regulate the audit profession. Though, only time will tell whether this step would help the growth and quality of the audit profession; however, the debate about expectation gap is not going to die down soon.

The background to this debate is whether this expectation is in keeping with the existing role and responsibility of an auditor or is it redefining such role and responsibility. In conduct of the audit, auditors are guided by the *Standards on Auditing*, which are formulated generally on the premises of public interest.

One would need to view from the prism of there being enough safeguards built into the audit process and reporting, whereby the auditor is required to act in public interest.

The power and duties of an auditor including the requirement for compliance with the Auditing Standards are laid down in Section 143 of the Act. Specific Acts such as Banking Regulation Act, 1949 and Insurance Act, 1938 also provide additional requirements in respect of audit of the banking companies and the insurance companies, respectively. Auditing Standard "SA 200 Overall Objective of the Independent Auditor" provides, *inter alia*, that in conducting an audit of financial statements, the overall objectives of the auditor is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework.

The Standard further provides that an audit in accordance with Standards is conducted on the premises that management and, where appropriate, those charged with governance have responsibilities that are fundamental to the conduct of the audit. The Standard also mentions about the Inherent Limitations of an Audit in such that the auditor is not expected to, and cannot, reduce audit risk to zero and cannot therefore obtain absolute assurance that the financial statements are free from material misstatement due to fraud or error. This is because there are inherent limitations of an audit, which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor's opinion being persuasive rather than conclusive. Thereby, it can be seen that an audit of financial statements conducted under Standards on Auditing is designed to achieve certain objectives. It also needs to be distinguished from a fraud detection and investigation assignment which focuses on detection and establishment of fraud and requires different skill sets. The Standard on Auditing SA 240 deals with the auditor's responsibilities relating to fraud in an audit of financial statements. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. The auditor is responsible for maintaining professional skepticism throughout the audit, considering the potential for management override of controls and recognising the fact that audit procedures that are effective for detecting error may not be effective in detecting Fraud. It may be noted that the reporting requirements under Section 143(12) of the Act lay down the auditor's responsibilities in the context of reporting on frauds; however, these requirements are in the context of carrying out an audit under SAs that do not envisage that the auditor's role is to detect frauds.

The perception of an auditor's duty with regard to the detection and prevention of fraud is also brought out very clearly in the famous *Kingston Cotton Mills Judgement* way back in the year 1896, where the Hon'ble Judge Lopes had summed up the auditor's duty and said: *Auditor is a watchdog and not a bloodhound.*

The Standard on Auditing SA 240 deals with the auditor's responsibilities relating to fraud in an audit of financial statements. The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management.

Necessity of Additional Information

Auditing Standard SA 700 provides the requirement for audit reporting by an auditor in respect of unmodified reports. Even though reports may be unmodified, there are additional reporting requirements prescribed by many of the regulators such as Companies Auditors Report Order (CARO) mandated by Ministry of Corporate Affairs (MCA), Long Form Audit Report (LFAR) recommended by Reserve Bank of India (RBI), additional questionnaire prescribed by the office of Comptroller and Auditor-General (C&AG) of India under Section 619(3) of the Act, etc. It shows that the users of financial statements and regulators require responses to certain specific queries, which they have regarding the auditee entities that they do not obtain from the standard format of the auditors' report under SA 700. The direction of additional requirements are often focussed at knowing, amongst other things, whether the transactions entered into by such entities or the working of such entities are against the public interest.

Additional reporting requirements in CARO: Central Government requires the auditor to provide comments on specific matters as per the questionnaire which *inter alia* include compliance with regularity and default in payment of statutory dues, related party transactions including loans, non-cash transactions, loans to and investments in parties, in which directors are interested and reporting on frauds. All such matters, being reported by an auditor, cover matters of public interest.

Internal Financial Control (IFC): The Act has mandated auditors to include in their report specific matters on the internal financial control mechanism existing in the companies. This applies to almost all companies beyond a threshold. While the principal responsibility of laying down the framework of IFC lies with the Directors of the companies, the auditors are supposed to comment on their existence, adequacy and effective operation in the company. However, auditors are supposed to restrict their procedure to the impact on the financial reporting only (ICFR). This additional responsibility imposed on the auditors is also an additional step towards safeguarding public interest and bridging the expectation gap.

Result of an audit is a reasonable assurance on the truth and fairness of the financial statements and not an absolute assurance. However, the expectation of stakeholders is completely different. The Institute of Chartered Accountants of India should play a major role in managing this expectation of stakeholders by explaining them clearly as to what constitutes an audit and what the procedures an auditor should follow are in normal course as per the Standards.

Changing Role of Auditors

Auditors are increasingly being asked to carry out their engagement with a much higher level of skepticism. The public expectation is that auditors should play the role of guarantors of their stake. It would be worthwhile at this juncture to keep in mind that auditors are external and independent; they have limited access to the original documents and have time constraint. Auditors are expected to do their audit procedure with all diligence and as per the Standards of Audit and ethical framework. Result of an audit is a reasonable assurance on the truth and fairness of the financial statements and not an absolute assurance. However, the expectation of stakeholders is completely different. The Institute of Chartered Accountants of India should play a major role in managing this expectation of stakeholders by explaining them clearly as to what constitutes an audit and what the procedures an auditor should follow are in normal course as per the Standards.

International Scenario

IAASB Chair Prof. Arnold Schilder: *From independent research and intense outreach we had learned that the audit opinion is valued, but could be more informative; users want more relevant and decision-useful information about the entity and the financial statement audit.*

The audit profession globally is going through a challenging time and India is no exception to that. The expectation of stakeholders is increasing on one hand, and on the other, the frequently-changing laws, rules and regulations are only adding to the misery. Public confidence on the auditors is enormous and very rightly so. They have been given a place of trust and fidelity by the society. Auditors' communication through their reporting is being watched carefully by every strata of the society and every communication in their reports are being relied upon by the stakeholders daily for their decision making. It is becoming imperative for the auditors to provide more and more information in their reports. Mere

Communicating key audit matters provides additional information to users of the financial statements and auditor's report thereon to assist them in understanding those items that, in auditor's professional judgment, were most significant to the audit. Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgment in the audited financial statements.

opining that the state of affairs is fair and/or true is not going to help the users anymore, it seems. The audit reports requiring more and more information about the auditee and its functioning is going to help the regulators, tax authorities, investors, lenders, analysts and all other users. The International Audit and Assurance Standards Board (IAASB) has been working towards making more mature and decision-useful reporting formats. In India, ICAI has issued similar reporting formats to be issued by the auditors from the year 2018-19.

In its efforts in modernising the ISAs for an evolving business environment and to ensure auditors' heightened level of skepticism in audit, IAASB has taken up some important projects in hand and is working relentlessly in a time-bound manner:

- In ISA 540 revision process, some of the new thoughts are, recognising the increased use of modelling, forward-looking assumptions, external information sources, reinforcing professional scepticism through enhanced risk assessment requirements, more granular work effort requirements, use of inherent risk factors in identifying and assessing the risks of material misstatement for accounting estimates, a broader approach to disclosures for all accounting estimates and the requirement to "stand back" and evaluate the audit evidence obtained.
- In ISA 315 revision, the thrust area again is Public Interest. In doing so, the proposal includes enhancing the auditor's approach to risk assessment critical to audit quality in recognition of an evolving environment, understanding what can go wrong, use of technology and data analytics, clarifying when controls are relevant to the audit, risk assessment process to be more rigorous and comprehensive, clarifying significant risks and that the relationship between risk assessment and estimation uncertainty, complexity, judgment and management bias.
- As a large step towards Quality control in Audit, ISQC 1 and ISA 220 are also being revised to ensure a robust Quality management program at the firm level and enhanced quality at the engagement level. A separate standard ISQC 2 is being thought of to ensure a stronger mechanism on the engagement quality control review process.
- Use of Data Analytics, Emerging External Reporting, Audit Evidence, Agreed Upon Procedure are the areas where the Board is working to raise the bar in safeguarding public interest.

PCAOB recommendations AS 3101 and 3105: PCAOB, constituted by the Securities Exchange Commission in US, prescribes auditing standards in the US for the entities listed with recognised stock exchanges. It has also recently brought out changes in their standards introducing requirements for compulsory reporting on critical audit matters (CAM), which is similar to reporting on KAM.

Format of New Auditors' Report

It is not only important for the auditors to communicate more in their report but it is essential to know when, where and how to report. Revised ISA 700 is thoroughly revised and new format requires the auditors to provide their opinion in the first paragraph of the report along with the basis for their opinion and the balance of the information in the later part. It is felt that the opinion is all that important in the report and hence, auditors should communicate their views on the opinion at the very beginning of their report to draw maximum attention of the readers.

Key Audit Matters (KAM)

Background of the new Standard ISA 701 on KAM is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed. Key audit matters provides additional information to users of the financial statements and auditor's report thereon to assist them in understanding those items that, in auditor's professional judgement, were most significant to the audit. Communicating key audit matters may also assist intended users in understanding the entity and areas of significant management judgement in the audited financial statements. Key audit matters are those matters which in the auditor's professional judgement were of most significance in the audit of financial statements. This requires the auditor to report in a separate section in the Audit Report out of matters reported to those charged with Governance which the auditor feels are of significance to the audit process. The standard is applicable for listed companies and for those companies where either the Law requires the auditors to do so or the auditor feels that he should be reporting on KAM. There could be various challenges in implementation of the standard as auditors and audit Committees struggle to identify and agree upon what should and should not be reported under KAM and also trying to establish the relationship between a KAM and the modifications in an audit report.

Going Concern....Compulsory Comments by Auditors

ISA 570 has also been revised and requires the management to include in the auditors report a specific paragraph on the management responsibility in connection with going concern. The auditors shall have to necessarily include a separate paragraph in case there is a material uncertainty regarding going concern.

The afroresaid amendments have also been made in the auditing standards in India, i.e. SA701 and SA 570 effective for audit of the financial statements relating to the period commencing from 1st April 2017 or 2018, as the case may be.

Modifications in Auditors' Report

Auditing Standards also require that in respect of unadjusted misstatements which are material the auditor would need to modify in the audit report. The nature of such modification, i.e. qualification, modification and disclaimer would depend on sufficiency and appropriateness of the evidence and whether the misstatements are pervasive or not. SA 705 deals with all the types of modifications in the audit reports.

The auditing standard-setters globally as well as in India, both IAASB and ICAI, are conscious about the large and ever-growing expectation gaps between the role that auditors are playing today and the comfort that stakeholders are expecting from the auditors.

Securities and Exchange Board of India (SEBI) has introduced, a few years back, a Qualified Auditors Report Review Committee (QARC) to pick up all modified audit reports from the stock exchanges and instruct the companies to necessarily give a statement of adjustment of the qualifications at the time of publishing the financial results.

Will the Above Really Safeguard Public Interest?

The auditing standard-setters globally as well as in India, both IAASB and ICAI, are conscious about the large and ever-growing expectation gaps between the role that auditors are playing today and the comfort that stakeholders are expecting from the auditors. There is a concerted effort to raise the bar for the auditors to do their job with a heightened level of skepticism and falling on a stand back approach. The auditors are expected to wake up and respond to the call in that respect to act in public interest. However, it is to be seen whether the auditors are actually "speaking up" under the new reporting requirements.

Equally important is for the stakeholders to read and understand the auditor's opinion and comments. We firmly believe that the regulators should have a robust mechanism to read and follow up on the modifications and comments on the auditor's report, if any. Any modification in the audit report should get highest attention and immense importance. The SEC in US does not permit an auditor's report to carry qualifications as they require both the management and the auditors to walk an extra mile and work on the differences, if any and ensure that the final audit report is an unmodified one. Finally, to safeguard Public Interest, auditors' reports should be more communicative and the management should work on every comment that the auditors may include in their reports to ensure that the final report from the auditors are clean and unmodified. ■

It's the possibility of having a dream come true that makes life interesting. - Paulo Coelho