Auditors: The harbingers of Investor Confidence

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We have one of the best corporate systems to foster economic growth and collaboration. The overwhelming majority of entrepreneurs, corporate executives and consultants are highly committed to the long-term success of the companies they drive. Don't get me wrong. Yes, some of them may have crossed boundaries and lost public trust. In the face of growing economic activity, capital markets boom, mergers & acquisitions, and foreign direct investments, it is imperative that investor confidence remains unshaken.

The past few years saw a dearth of companies collapse, file for bankruptcy and loose investor confidence like Kingfisher Airlines, Yes Bank, Dewan Housing Finance, Essar Steel, Punjab National Bank, IL&FS, etc. Consequently, several regulators have stepped up measures to prevent such mishaps and increased the responsibilities of the auditors.

So, are auditors the harbingers of Investor Confidence or does there lay before an auditor raising the curtain, a sea of unnoticed clues?

Evolution of audit and auditing framework today!

With an increase in exposure to various kinds of risk, the role of an auditor has grown tougher and more important than ever before.

The Ministry of Corporate Affairs (MCA) replaced the Companies Act, 1956 with the Companies Act, 2013 and brought about a major shift in the responsibilities of directors and the auditors. Auditors are prohibited from providing certain non-audit services. They must now mandatorily report on the consolidated financial statements, internal financial controls, managerial remuneration and various other matters. Gradually, the accounting standards converged with IFRS and IndAS became the mandatory accounting standards for listed companies. The Security & Exchange Board of India (SEBI) now require listed companies to be audited by only peer reviewed auditors. Published financial results now include the balance sheet and cashflows. Listed company auditors cannot resign without detailed discussions with the audit committee and filing their reasons with the MCA and SEBI. They have to now complete the previous/next quarter's review before they can walk out.

Earlier audit procedures were largely restricted to vouching and verification. Today, auditors have extended their testing to internal controls, evaluation of Information Technology systems, use of specialist and experts for audit of tax complications, fair valuations, litigations, related parties, etc. Auditors now follow a risk-based approach which requires them to delve deep in the business of their clients to identify potential risk and then formulate audit procedures to mitigate those risk.

The 'single page' auditors' report now expands to a number of pages with detailed reporting on various matters such as internal controls, frauds, cash losses, loans and advances to directors and others, defaults in repayment of loans, property plant and equipment, immovable property, inventory, director eligibility, unpaid and disputed statutory dues, managerial remuneration, corporate social responsibility spending, quarterly statements filed with banks for working capital facilities, whistle blower complaints mechanism, related party transactions, etc. and the list seems never ending.

What should investors watch out for?

We have had a successful bull run for some time now. Long bull markets always seem to result in certain laxity and complacency. Investors don't like surprises and expect companies to generate predictable earnings and demonstrate continuous growth. Investor confidence is not mainly on the earnings of a company but on the price of a stock which is based on several factors including forecasts put out there by the management. The reality is that most businesses are exposed to inherent risks. I believe the need of the day is for investors to read between the lines the information put out there by the management and auditors.

With the enhanced role of the auditor, below are some of the matters to watch out for:

Who is the auditor?

Which Chartered Accountant firm is being appointed? Did the Board of Directors choose their auditors wisely keeping in mind the industry they belong to, experience and history of the auditor, etc.?

Areas being qualified / disclaimed

Any matter being qualified/disclaimed in the auditor's report, limitations on scope imposed by management and explanation in the board's report for such matters being reported by auditors. These matters usually highlight major problems in the company/with the management and should be considered the greatest red flag for any investor.

Material weaknesses in internal controls

The auditor reporting any material weaknesses in internal controls could highlight areas with high potential for misstatements. These indicate weak systems which also reflect poorly on management competence and governance.

Matters reported in the Companies (Auditor's Report) Order, 2020 (CARO Report)

Auditors are required to report in a separate annexure

(CARO Report) to his report on matters prescribed by MCA. CARO 2020 became effective from FY 2021-22, and auditors now must report on 21 clauses as against the 16 clauses specified earlier in CARO 2016. These include cash losses, loans and advances to directors and others, defaults in repayment of loans, property plant and equipment, immovable property, inventory, unpaid and disputed statutory dues, managerial remuneration, corporate social responsibility spending, quarterly statements filed with banks for working capital facilities, whistle blower complaints mechanism, related party transactions, etc.

A thorough reading of the CARO Report can reveal several anomalies in the operations and transactions of the company.

Going concern assessments and specific disclosure in the auditor's report

Any remarks made with respect to going concern stated in the 'Material Uncertainty with respect to the Going Concern' paragraph in the auditor's report should be considered as a wake-up call. These would highlight any major business risks or cash flow/liquidity concerns being faced by the company.

Matters reported under Key Audit Matters (KAMs) paragraph in the auditor's report

A most significant step in the history of audit reporting was the introduction of KAMs. It gave voice to the auditor's pain points. The audit procedures and their outcome found place in the audit report. These are matters of significant judgements, estimates and risk. This section brought some of the audit committee controversies to the shareholders. Investors should be alert to the KAMs being reported by auditors. Due to their nature, these have a high possibility of misstatements in the future.

Delays in closure of books, postponement of AGM and unexpected resignation of auditors

Investors should look out for delays in closure of books by the management and audit/review thereof or instances of an auditor's refusal to signing of the auditor's report and resigning from his post or frequent change of auditors. These could be signs of major problems within the company. The reasons for resignation by the auditor are stated in filings with the MCA and SEBI. These could reveal potential and material issues within the company. One must evaluate reasons for change in auditors.

The Top 5 reasons for resignation of auditor are:

1. Non-receipt of vital information
2. Risk of reputational damage to the audit firm on discovery of financial frauds at the client
3. Regulatory investigations at the client
4. Compliance with Code of Ethics requiring auditors to resign from the audit engagement
5. Audit fees being inadequate to meet the estimated cost of doing the audit

Review Reports

Management and auditors are open to reviewing the estimates made in preparing the quarterly results at the year end and it is not uncommon to see a 360 degree change in an estimate, or a qualification based on the outcome of the audit at the end of the year. While stakeholders need to appreciate the limitations of a review, matters reported in the review report most of the time find their place in the audit report as well.

The above are red flags, investors and stakeholder should pay attention to. These reflect the financial health, management integrity, business ethics and prospects of a company. Of course, one should read the fine print before concluding. But these are surely not to be ignored.

While auditors play a significant role in reflecting the fairness in financial accounting and communicating confidence to investors, one needs to appreciate that audit is a post-mortem activity, i.e., the auditor's report comes at the end.

Corporates are communicating! Are we listening?

Our corporate governance framework with its multiple mandatory filing requirements with MCA and SEBI keep companies on their toes. They are communicating frequently with stakeholders. These include acquisitions, disposals, frauds, change in directors, Key Managerial Personnel, material contracts, reasons for resignation of independent directors and auditors, related party transactions and a whole lot of material events that impact the company.

The above disclosures along with the quarterly financial results, audited financial statements (along with detailed notes to accounts) are out there in public domain for investors' consideration. They are comprehensive and reflect the business and management angles and these disclosures are ever increasing.

In addition to financial statements, investor confidence also depends on a multitude of other information when making investment decisions including sustainability reports, environmental, social, and corporate governance matters and other responsibility reporting.

Most investors and stakeholders do not follow these trails leading to the company's performance and the onus then rests with the auditor for breaking the news. It is important to remember that while we may want to blame the auditors for oversight, we should be mindful that it is the Promoters/Board of Directors who are the perpetrators in the first place. An auditor is a watchdog not a blood hound. If he/ she has done their work with reasonable care and skill and a fraud is detected later, then the auditor is not liable on any account.

With enhanced and timely disclosures and auditors' reports running into pages, we are looking at investor confidence moving up. Also, the ever-watchful eye of regulators and their actions recently are gradually taking the credibility of corporate India to the top of the world map. However, no matter how much regulators and auditors do, it is imperative that investors do not overlook the disguised flags which are the real harbingers of investor confidence.