Importance of an External Audit

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Purpose of the financial statement audit

Since its introduction, the need for certain companies' financial statements to be audited by an independent external auditor has been a cornerstone of confidence in the world's financial systems. The benefit of an audit is that it provides assurance that management has presented a 'true and fair' view of a company's financial performance and position. By 'True' it is meant that the information from the financial statement is factual and conforms to reality (numbers based on genuine transactions that have truly occurred) and by 'Fair' it is meant that the information is free from discrimination and bias, and complies with accounting standards and rules (estimates and judgmental decisions made by the company are a fair representation according to the accounting standards).

Users of a financial statement audit report

Companies produce financial statements that provide information about their financial position and performance. This information is used by a wide range of stakeholders (e.g.,investors) in making economic decisions. Typically, those that own a company, the shareholders, are not those that manage it. Therefore, the owners of these companies (as well as other stakeholders, such as banks, suppliers and customers) take comfort from independent assurance that the financial statements fairly present, in all material respects, the company's financial position and performance. To enhance the degree of confidence in the financial statements, a qualified external party (an auditor) is engaged to examine the financial statements, including related disclosures produced by management, to give their professional opinion on whether they fairly reflect, in all material respects, the company's financial performance over a given period(s) (an income statement) and financial position as of a particular date(s) (a balance sheet) in accordance with relevant GAAP.

Auditor required qualifications and skills

Auditors are generally qualified accountants who are members of a professional institute in their respective countries. Although this varies between countries, qualified accountants normally must meet certain educational requirements, take several years of studying and professional exams (ex. ACCA) and have sufficient practical experience.

Who is required to undertake an audit?

Public companies, private businesses, and nonprofits may all be required under law to provide annual audited statements to ensure compliance with regulations and to provide sufficient financial disclosures. From one country to another, the regulation regarding the necessity of a company to have its financial statements audited differ, depending on the GAAP.

For instance, in the Czech Republic joint-stock companies are required to have their financial statements audited by a registered auditor if one or more of the following criteria are met for both the current year and the preceding year:

- the net turnover exceeds CZK 80 .000.000 per annum (approx. € 3.000.000);
- the total assets exceed CZK 40.000.000 (approximately € 1.500.000);
- the average number of employees exceeds 50

Auditors' duties

The principal duty of the auditors to a company is to report to the members of the company on the financial statements examined by them. The auditors' report must state whether, in their opinion the company has maintained proper books of account; the financial statements have been properly prepared in accordance with the provisions of the regulation and give a true and fair view of the company's affairs and of its profit (or loss); Where the auditors cannot report positively on any of the above matters, they may find it necessary to 'qualify' their audit report giving reasons for the qualification. A qualified audit report can take three forms, namely:

- a '*qualified opinion*', in which the auditors state that the financial statements give a true and fair view, except for certain matters which the auditor will specify in the report;
- a '*disclaimer of opinion*', in which the auditors state that they are unable to form an opinion as to whether the financial statements give a true and fair view. A disclaimer of opinion will arise where the scope of the auditors' work has been limited in some way e.g. they have been unable to gain access to all of the books and records, or;
- an '*adverse opinion*', in which the auditors state that the financial statements do not give a true and fair view. An adverse opinion will be given where the auditors are in disagreement with the financial statements and the directors are not prepared to amend them to reflect what the auditor considers to be a true and fair view.

Auditors’ rights

Auditors have the right of access at all reasonable times to the books, accounts and vouchers of the company. They can require from the company’s officers and employees such information and explanations that are necessary for the performance of their duties. A person who fails to comply with such a request within a reasonable time, or who knowingly gives false information, is in breach of the Law.

Auditors are entitled to attend any general meeting of the company and to receive the same notices and communications relating to meetings as the members. They also have the right to be heard at all general meetings on any part of the meeting that concerns them.

What powers do auditors have?

It is important to understand that auditors are not the ‘finance police’. They are not in a position to dictate how an organization should go about its business or directly punish organizations that engage in risky, underhand or deceitful activities. In essence, the auditor’s power lies in the fact that their opinion on an organization’s financial position is seen as important by the organization itself and by anyone with an interest in the health of the organization – shareholders, suppliers, customers, tax authorities to name just a few. This opinion is trusted enough to affect the decisions these groups make about their own dealings with the organization

Appointment of auditors

The first auditors of a company may be appointed by the directors or by a general meeting of the company. After that, the auditors are appointed by the members of the company in annual general meeting and hold office until the next such meeting.

Removal and non-reappointment

Auditors may be removed by resolution of a general meeting or by way of resolution appointing someone else instead of them.

Where such a course of action is proposed, auditors are entitled to contest their proposed removal and to explain the circumstances of their proposed removal to the members.

An auditor is permitted to resign from office before the expiry of his or her term of appointment by serving notice in writing on the company. Resigning auditors or auditors who are unwilling to be reappointed must state in their notice of resignation the circumstances connected with the resignation which they consider ought to be brought to the notice of the members and creditors or if there are none, that no such circumstances exist.

Audit stages

Exactly how an audit is carried out will depend on the nature of the organization being audited. However, most auditors follow a broadly similar process, working closely with their clients’ senior management and guided by a set of ‘International Standards’ – essentially these are designed to ensure that audits are carried out in the same way the world over, whilst allowing auditors to follow rules and regulations set out by individual countries.

In general terms, an audit will cover:

- **Planning and risk assessment:** This is a process of getting to know the organization being audited as well as any issues that commonly affect similar organizations when it comes to financial reporting. The auditor will also use this process to identify any areas that may need special attention.
- **Internal controls testing:** This aspect of audit has become a lot more important in recent years. It is about working out whether the control systems in use are sufficiently robust and reliable, and whether they comply with any regulations the organization is subject to. The results of this work will determine how the rest of the audit process is carried out
- **Substantive procedures:** This is the process of gathering the evidence needed in order to assess whether an organization’s claims about its financial position are fair and accurate. The strength of the organization’s internal controls will go a long way to determining how detailed this process is. Broadly, there are two substantive procedures:
- **Substantive Analytical Procedures:** This process is used if internal controls are deemed to be reliable and robust and is essentially the comparison of sets of financial information to see if the accounts 'make sense' when viewed from different perspectives
- **Substantive Tests of Detail:** If internal controls are deemed to be weak, absent, or have not been tested, then a ‘test of detail’ approach will be taken. In essence, this is a process of selecting a sample of items from the organization’s accounts, then finding hard evidence (e.g. invoices, bank statements) to check that they have been properly accounted for.
- **Finalization:** With all this assessment work carried out, the auditor will use the information gathered to write a final report – which is an independent opinion of the organization’s financial position. The auditor will also prepare a letter or report for the organization’s management, setting out any important issues that came to light whilst the audit was being carried out.

Ethical values and behavior

Ethics refers to the study of moral principles or values that determine whether actions are right or wrong and outcomes are good or bad. People rely on their ethical values to determine “the right thing to do.”

Unfortunately an ongoing stream of incidents involving corporate wrongdoing continues to raise serious questions about the ethical values of many corporate leaders. Scandals at Enron, Worldcom, Tyco, and other companies led to the Sarbanes-Oxley Act in 2002, which put more controls on U.S. companies and auditing firms to minimize conflict of interest and disclose companies’ financial pictures more fully. This legislation might reduce some unethical conduct, but wrongdoing is unlikely to disappear completely.

Arthur Andersen Example:

Arthur Andersen is a real life example why in some cases even though a court decision is not terminal the damage to the Company‘s reputation will prevent it from returning as a viable business, though it still nominally exists.

Arthur Andersen LLP, based in Chicago, is a holding company and formerly one of the "Big Five" accounting firms among PWC, Deloitte Touche Tohmatsu, EY and KPMG, providing auditing, tax, and consulting services to large corporations.

In 2002, the firm voluntarily surrendered its licenses to practice as Certified Public Accountants in the United States after being found guilty of criminal charges relating to the firm's handling of the auditing of Enron, an energy corporation based in Texas, which starting with 1993 until 2001 had dubious energy trading schemes and accounting practices. Enron’s complex and dubious accounting schemes allowed Enron to reduce its tax payments, to inflate its income and profits, inflate stock price and credit rating, hide losses in off-balance sheet subsidiaries and fraudulently misrepresent Enron’s financial condition in public reports. At that time Arthur Andersen LLP was Enron’s external auditor.

Following the 2001 scandal in which $100bn in revenue from what it was considered an energy giant - Enron was found to have sustained itself by means of institutional and systematic accounting fraud, Andersen's performance and alleged complicity as an auditor came under intense scrutiny. It is important to mention that by that time the team auditing Enron was not rotating (same audit team was performing audit of Enron financial statements for the entire year); the fee received from Enron in year 2000 was $52mln - and most of it for consulting services and not audit, a fact that raised doubts about Arthur Anderson independence;

Arthur Andersen was accused that it did not fulfill its professional responsibilities in connection with its audits of Enron's financial statements, or its obligation to bring to the attention of Enron's Board (or the Audit and Compliance Committee) concerns about Enron's internal contracts over the related-party transactions. Andersen was convicted of obstruction of justice for shredding documents related to its audit of Enron. Since the U.S. Securities and Exchange Commission cannot accept audits from convicted felons, the firm agreed to surrender its CPA licenses and its right to practice before the SEC on August 31, 2002—effectively putting the firm out of business. The Supreme Court of the United States unanimously reversed Andersen's conviction due to what it saw as serious flaws in the jury instructions which theoretically left Andersen free to resume operations. However the damage to the Andersen name was so severe that it has not returned as a viable business even on a limited scale. There are over 100 civil suits pending against the firm related to its audits of Enron and other companies.

As a conclusion I would say that unethical companies will eventually get exposed: Witness Enron. Companies that live and breathe their missions, by contrast, will get recognized by both the retail and capital markets. Stock values, of course, are a function of multiple factors. But solid principles are good for business, and ultimately good for corporation valuations.

Auditor independence

With the above example I wanted to make clear how important the auditor’s independence is. Shareholders need to have confidence that the auditors have assessed relevant information objectively, and that they have scrutinized evidence critically and independently. Shareholders also want to be sure that the auditors have undertaken their work and made their judgments free from any bias, and without being influenced unduly by management who prepared the financial statements.

Specific requirements vary around the world, but generally include:

- Prohibiting the auditors from holding an interest in (whether financial or through close relationship with) the company they are auditing;
- Prohibiting the auditors from providing the company with certain services (such as implementation of accounting IT systems or hiring employees) that could compromise their objectivity; and
- Requiring key personnel on the audit to be changed from to time to time, so that fresh pairs of eyes are brought to bear including regular rotation of the lead audit partner.

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