Public Accountability of Public Enterprises: C&AG's Oversight Role (Part-II)

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Some Interesting Studies on Fraud and Creative Accounting

According to World Bank report on 'Observance of Standards and Codes-Accounting and Auditing', the Ministry of Corporate Affairs has the mandate to monitor general purpose financial reporting which is exercised primarily through statutory audits. SEBI does not proactively monitor compliance with Clause 49 of the Listing Agreement and financial reporting requirements. Bombay and National Stock Exchanges insist on external auditors to monitor compliance with the accounting and disclosure requirements. A large number of listed companies in the private sector have been indulging in financial statement frauds. Cases of Global Trust Bank and Satyam are most commonly known. Some of the studies conducted in India revealed that companies have been using techniques of creative accounting.

The joint research conducted by the ICAI and Indiaforensic on "Early Warning Signals of Corporate Frauds in India" revealed that 20-30 percent clients commit the financial statement frauds in India. The major categories of frauds related to cash, inventory, accounts payable, accounts receivable, payroll, and revenue recognition schemes. The major industrial sectors where frauds were identified include manufacturing including pharmaceuticals, real estate and construction, government and public administration, banks and non-banking financial sector, insurance, oil and gas, services, transport and warehousing, media, IT companies etc. An analysis of 500 companies listed on Bombay Stock Exchange conducted by Noble Bank revealed that companies resort to creative accounting at times of heightened economic stress characterized by economic slowdown in GDP growth combined with profit margin pressure. Prevalent creative accounting practices of the BSE listed companies were identified as recording revenue ahead of time, booking fictitious sales, expense and cash manipulations, invisible restatements of prior periods. The research findings are briefly the following:

- At least 30 companies had been using aggressive revenue recognition techniques;
- Around 60 companies seem to have booked sales which might have arisen from investment income or other income;
- At least 10 companies had shifted expenses away from the current period by significantly reducing deprecation rates;
- At least 15 companies which have disbursed the bulk of their loans and advances to companies in which Director have interest;
- At least 25 companies had profits shown in the full year results significantly lower than the sum of quarterly results.

These studies establish that there is an increasing need for regulators like Ministry of Corporate Affairs, Registrar of Companies, Ministry of Finance, SEBI, RBI, ICAI and Stock Exchanges to gear up their machinery to curb the unethical creative accounting tendencies, unprofessional conduct of auditors, non adherence to corporate governance tenets and fraudulent transactions

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of private sector companies including those of listed ones and furthering corporate governance principles in their functioning. It is obvious that the system of audit of financial statements of listed companies advocates that there is a need for oversight functions or supplementary audit not only for audit of PSEs but also for other listed companies in the private sector protect the interests of large number of minority shareholders. Three Phased Audit System and Other New Initiatives in Audit of Central PSEs.

The root causes of Satyam scam may have yet to be fully investigated and identified but the fraud has exhibited major accounting irregularities, weaknesses in the control environment , failure on the part of the independent directors and the audit committee to ensure corporate governance and negligence on the part of auditors leading to credibility crisis on audit and accounting functions. There is growing expectation gap and demand from the public for re-evaluation of the contemporary Indian accounting and auditing norms, revisiting the audit working processers, principles, procedures and practice to deter possibilities of indulging in deliberate frauds, misreporting and misleading stakeholders.

In order to meet the emerging challenges and to suit the changing environment especially in the backdrop of recent fraudulent transactions in listed companies, the C&AG has issued additional directions to the statutory auditors regarding their party confirmation in respect of bank and cash balances, investment, creditors and debtors while introducing more intensified, innovative, focused and result-oriented approach to financial audit by 'The System of Three Phased Audit'. With a view to bring substantial qualitative transformation in the audit process and methodology, it is imperative to change the mind set of auditors along with innovative strategic transformation in audit approach, targeted to bringing value addition usefulness,credibility, transparency, visibility and acceptability. Realizing that strengthening the financial reporting system of the PSEs and thereby help implementing internationally benchmarked best corporate governance practices being the ultimate objective of audit, various innovative measures have been initiated for audit of central PSEs recently. Besides, in 'Three Phased Financial Audit System' added emphasis is given to risk based audit approach, corporate governance and intensification of communication process with all players concerned including statutory auditors, management and other regulators as well.

Some of the strategic changes introduced are briefly given below:

Introduction of 'Three Phased Audit System'

The prime objective of supplementary audit is enhancing the quality of financial statements. Currently financial statements are cluttered with innumerable notes on accounts, qualifications without quantifying the impact, while certifying the financial statements as true and fair. There is a need for better understanding, effective communication, and exchange of views to bring consensus and convergence of ideas in regard to accounting principles, treatment of different accounting entries, application of mandatory accounting standards among the management executives, government auditors, and the statutory auditors, who are actively involved in the financial reporting and audit process with distinct roles and responsibilities. The ultimate test of a qualitatively superior financial reporting is its readability, simplicity and usefulness to different stakeholders including investors in decision making. Responsibility of an auditor whether he is functioning as statutory auditor or government auditor is essentially strengthening the financial reporting system in the enterprise and thereby facilitating the PSEs to increase its profitability by expanding its core business activities rather than scoring over one another by presenting erudite arguments and counter arguments leading nowhere but help confusing and bewildering the hapless reader of the financial statements. With this objective in mind, a new audit approach viz. 'Three Phased Audit System' has been introduced from the accounting year 2008-09 in 78 selected Central PSEs out of total 419 companies and statutory corporations, falling under the categories of 'listed', 'navratna', 'miniratna' government companies, and 'statutory corporation' where C&AG is the sole auditor.

The new audit approach has three phases aiming at:

- Establishing an effective communication and a coordinated approach amongst the statutory auditors, managements and C&AG's audit parties for removal of inconsistencies and doubts relating to the accounts presented by the PSEs.
- Identify inconsistencies, if any, before approval of the accounts by the Board of Director (BODs) of the PSEs, review the accounting of transactions and highlight errors, omissions, non-compliances etc. for timely remedial action to improve the quality of accounts.

- Providing adequate time and opportunity to the statutory auditors, and the managements of the PSEs to examine the issues identified by the C&AG and make necessary modifications in the accounts instead of presenting the accounts along with observation of statutory auditors and comments emanated from the C&AG's supplementary audit; and
- Reducing the time for supplementary audit after the accounts are approved by the BODs of PSEs.

To familiarize the audit entities and the statutory auditors of the objectives and methodology of the new audit approach and to elicit cooperation in implementation, 13 high level tri-party meetings were organized bringing the management, government auditor, and statutory auditor for detailed deliberations from deliberations from December 2008 to January 2009 in Bangalore, Delhi, Mumbai, Hyderabad, Kolkata and Kochi. Detailed guidelines were issued to elucidate the process and procedure as under. The pre requisites for Three Phased System of Audit of Annual Accounts.

- The PSEs agree to implement the system and extend active cooperation to audit.
- A proper and scientific audit risk assessment is undertaken before commencement of first phase of audit for assessing audit risk.
- Effective Interaction among the government auditor, management and statutory auditor for ensuring successful implementation of the system.
- As far as possible, the same audit team is assigned all the phases of accounts audit.
- The PSEs are expected to give their draft accounts to the concerned Member Audit Board office concerned along with Schedules to the draft accounts for conducting Phase-II of the audit.

Audit methodology

Audit of financial statements may be conducted in three phases as under:

Phase – I

Listed companies prepare quarterly financial results (QFR) and submit to the stock exchanges. Other major companies also prepare QFR or half yearly results (HYR). Phase-I audit is conducted on receipt of QFR of second quarter or first HYR . In case of the companies, which do not prepare QFR/HYR, Phase-I audit was conducted in the months of November-December.

Following aspects are covered in the Phase-I Audit:

- Understanding of the accounting system, including IT system, of the PSE;
- A proper risk assessment, including review of internal control system in the PSEs, may be conducted;
- Analysis of accounting policies, notes to accounts with reference to the applicable laws and disclosures in conformity with the accounting standards as per last years certified accounts; In subsequent years, emphasis should be made only on modifications / proposed modifications adoption of new accounting policies, accounting standards, relevant laws and regulations;
- An effort is made to bring consistency in the accounting policies of the companies in the same sector;
- Compliance with the previous year's assurances given by the management and issues raised in the 'Management Letters';
- Previous year's audit findings of the statutory auditors and of the C&AG Headquarters office;
- Modifications in the opening balances, if any, or rectification of errors done by the company may also be reviewed to evaluate the efficacy of the internal control system;
- Based on the above quantum of checks to be exercised and department/units to be visited, scope and coverage is decided. Further audit of the draft accounts to be submitted by the Management is conducted in phase-II;
- Issues of principle, accounting policies, accounting standards, opinions of the Expert Advisory Committee of ICAI are discussed with the management. Proposed changes in the accounting policies and Notes to Accounts are also discussed;
- Preliminary audit findings emanating from Phase-I and points of disagreements are brought to the notice of the statutory auditors. The Management of the PSEs are apprised of these audit findings. The issues involved are reconsidered after obtaining reply of the statutory auditors and the management. Final view is taken at MAB level and communicated to the statutory auditors of the PSE in the form of MAB's sub-directions under Section 619(3)(a) of the Companies Act 1956. The Management of the PSE is apprised of the final view to elicit

cooperation towards attainment of the objective of compliance with the accepted commercial accounting principles, applicable laws and accounting standards etc, and

- Once remedial action is taken by the management, such cases are to be reported for inclusion in CAG's Report as value addition at the instance of C&AG audit. Cases of points of disagreement are processed as comments on accounts.

Phase – II

This is conducted as a test audit at the end of the financial year (i.e. in the month of April) based on the draft accounts received from the PSEs.

The following aspects are verified during this phase:

- Audit of the units selected in Phase-I based on draft accounts submitted by the PSE are conducted;
- Review of system of verification of inventories, cash and bank balances including fixed deposits, investments and other items to be finalized at year end and system of confirmation of balances of debtors, creditors, loans and advances, etc.;
- Instructions issued by the head office of the PSE to its units for compilation/consolidation of accounts. Any deviation in the instructions from the accounting policies, accounting standards etc. are taken up with the PSE;
- The PSEs are asked timely to render their draft accounts along with Schedules for the period ending third quarter of the financial year to the Member Audit Board (MAB) office concerned for conducting audit in Phase-II. In case any PSE is not in position to render the draft accounts with Schedules, detailed vouching is carried out on the basis of QFRs. Proper documentation with relevant records of the audit/vouching etc. done during the Phase are maintained for subsequent use and reference.
- Preliminary audit findings noticed as a result of test audit and vouching in Phase-II are issued to statutory auditors of the PSU in the form of sub-directions under Section 619(3) (a) of the Companies Act with a view to ensure that the statutory auditors conduct, inter-alia, thorough examination of all such related matters. In the event of non-compliance with the accepted commercial accounting principles, applicable laws and accounting standards, the statutory auditors are required to report appropriable in their report on the financial statements. The Management of the PSE is also apprised of the final view to elicit cooperation towards compliance with accounting principles, laws and standards etc.

Phase – III

On receipt of financial statements/ accounts duly approved by the Board of Directors of the PSEs and reported upon by the statutory auditors, the following aspects are verified during this phase:

- Verification of action taken on earlier audit observations;
- Compliance with the consolidation/grouping instructions;
- Review of memorandum of changes effected by the PSE in the approved accounts vis-a-vis the draft accounts on which audit in Phase-II was conducted;
- Accounting and disclosures of the events occurring after the balance sheet date;
- Final disclosures made in the approved accounts;
- Compliance with the financial reporting requirements of the relevant laws, rules and regulations, accounting standards etc.
- Examination of the Report of the statutory auditors especially the qualifications, opinions and compliance with relevant Auditing and Assurance Standards; and issue of draft audit observations to the statutory auditors as well as the management and to process the same for issuing as comments on accounts.
- The PSEs agree to implement the system and extend active cooperation to audit.
- A proper and scientific audit risk assessment is undertaken before commencement of first phase of audit for assessing audit risk.

In order to meet the emerging challenges and to suit the changing environment especially in the backdrop of recent fraudulent transactions in listed companies, the C&AG has issued additional directions to the statutory auditors of CPSEs to ensure third party confirmation in respect of bank balances, investment, loans and advances, creditors and debtors.

- Effective Interaction among the government auditor, management and statutory auditor for ensuring successful implementation of the system.
- As far as possible, the same audit team is assigned all the phases of accounts audit.
- The PSEs are expected to give their draft accounts to the concerned Member Audit Board office concerned along with Schedules to the draft accounts for conducting Phase-II of the audit.

Directions on Confirmation of Balances

In order to meet the emerging challenges and to suit the changing environment especially in the backdrop of recent fraudulent transactions in listed companies, the C&AG has issued additional directions to the statutory auditors of CPSEs to ensure third party confirmation in respect of bank balances, investment, loans and advances, creditors and debtors.

Risk-Based Audit Approach

In order to utilize the limited resources of Audit and to help PSEs in managing and minimizing the probability of inherent risk of financial impropriety in the activities carried out by them rather than being confronted with surprises on the matters related thereto, a risk based audit approach has been adopted. The objective of this approach is to select high risk areas with focused approach, and conduct systematic in depth audit probe taking statistically chosen representative samples of activities or units of an audit entity. This approach relocates audit focus from coverage of 'all accounting/auditable units' to coverage of 'all major areas of risk' based on objective assessment of risk factors, their significance, materiality and probable impact over a reasonable period of time with definite prompt follow up of audit to see that corrective and preventive actions are in place as a result of audit observations. With a view to give due weightage to financial audit, the audit strategy has been revamped allocating more or less one third audit resources for attestation audit leaving the remaining two third audit resources proportionately for performance audit and compliance audit depending on risk perception.

Interaction with Other Regulatory Bodies

In our country, the PSEs are governed by number of Regulatory bodies. The common regulatory Bodies are Ministry of Corporate Affairs, Department of Public Enterprises and the respective Administrative Ministry. In addition, PSEs are also regulated by other bodies like SEBI (for listed PSEs), IRDA (for insurance sector PSEs), RBI (for non-banking financial PSEs), CERC (for power sector PSEs). Each Regulatory body issues directions/guidelines in its area of operation to regulate the activities of the PSE. Thus, PSEs are required to follow and ensure the directives/ instructions of the various regulatory agencies. In order to ensure consistency in the directions issued by various regulatory agencies, it is necessary that there should be an effective interaction and coordination among them while framing the directives for PSEs to ensure that they are realistic and not inconsistent with the directives of other Regulatory bodies.

To enhance the interaction amongst the regulators of PSEs, 6 joint workshops were organized by ICAI in association with C&AG, at Delhi, Mumbai, Earnakulam, Kolkata, Lucknow and Jaipur in the month of May and June 2009. These workshops provided a platform to the statutory auditors of PSEs to interact with the representatives of ICAI and C&AG to brainstorm the emerging challenges for the audit profession and how to address them. This platform also facilitated effective communication between the C&AG and statutory auditors. To enhance the interaction with other regulators and exchange ideas training programmes wee organized for the officials of C&AG in association of RBI, SEBI and ICAI. As these interactions and training programmes were highly appreciated and similar programmes would be organized in future to learn from their experience and to optimize the level of knowledge of the participants to further enhance the accountability of the management of PSEs to the public at large.

To sum up, the statutory frameworks are in place, mandatory acts, regulations, rules, standards, principles, procedures, directions, guidelines and best practices are well known and aplenty; regulatory bodies overseeing the corporate business activities for effective enforcement are constituted, alive, kicking and functioning and board of directors, audit committee, independent directors, statutory auditors and government auditors are all in the corporate arena seized of the problems and issues with defined roles, tasks and responsibilities. The time has come for cooperation, coordination intense focused result oriented interaction, exchange of views among all the players in the corporate arena for better approach, methodology, and action plan to help one another in discharging their assigned role by coordinated and collective action.