Clarifying differences between public perceptions about the role of the auditor and the auditor's responsibilities in a financial statement audit

The perceived gap between auditor's responsibilities and financial information user's expectations is a classic principal-agent problem. Auditors profit from their services and consequently incentivized to preserve client-oriented relations with an auditee. Users may disagree with the financial reporting but that knowledge usually remains private and there is no formal way to provide relevant feedback and to pressure the auditors and organizations. Here are some real-life examples.

1. According to a decision by the government, ownership of a state-owned enterprise (SOE-1) was transferred to another holding SOE. The following year SOE-1 restored some of the previous write-downs of inventories leading to the increase in profit. Both SOEs reported the new management's success, as SOE-1 turned "operating profitable". Company restored inventory write-downs the next year with the same magnitude. It looks very like to a deliberate shift of the profits between years. Write-downs and reversals were hidden in the cost of the sales line in the income statement of the SOE-1.
2. The government pursues a policy of 50% dividend payout of profit for all SOEs. One electric power generating SOE routinely impairs value of newly installed capacities referring to non-economic tariffs on heat and electricity. Impairments decrease profits and, consequently, the dividends. For the purpose of fair value estimation of cash generating units company applied an unjustifiably high pre-tax discount rate of 15 - 17% (inflation target in the country is 4%, profit tax rate is 20%). At the same time, comparable SOEs with regulated tariffs apply 10-11% pre-tax rate. Significant impairment expenses were included in one number together with costs of sales in the Income statement.
3. One socially significant enterprise reported "assets for sale" combined in single big lump line in the Balance sheet supposedly for concealing a significant part of its cash. The assets for sales were impaired using a very high discount rate, and the corresponding costs were aggregated in the costs of sales in the Income statement. Finally, the enterprise applied for the government support justifying the claim with its overstated net debt and understated profits.

In all cases, relevant material information was buried in footnotes, and auditors were silent on the ways of calculation and presentation. As the government employs IFRS in the dividends' policy and for distribution of subsidies, for setting key performance indicators and management remuneration, one can find incentives to game the figures. Auditors have to safeguard fair representation, respecting materiality principle, and express opinion on doubtful revaluations. All discretionary accounting decisions (tangible and intangible asset write-downs, reserve creations, etc.) have to be scrutinized by the auditor. The presentation has to be strictly according to materiality principle. I believe it is more important than going concern and outright fraud issues. Going concern is a credit analysis, and appears to be the responsibility of investors and creditors. Fraudsters sometimes will find a way to defraud, and the auditors may be deceived.

This highlights a need for establishment of a feedback mechanism to fill the gap between user's expectations and the auditors work. This has to be an institutionalized and public way for the users to complain with subsequent assessment of the audit quality, be it some "court" or peer-auditors review.

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