Practice Note

Auditing Opinions for Sale?

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At a recent Graduation Ceremony of CMA Professionals of ICMA (Australia) in Sri Lanka; where the Chief Guest, Deputy Minister Eran Wickramaratne, lamented about the dearth of accounting professionals and professionalism. This was reported in the *Education Times* section of the **Sunday Times** on October 3, 2015.

Thankfully, the Minister was talking about Financial Accountants and Auditors. Mr Wickramaratne said he was in the Committee on Public Enterprises for 5 years and found that, most often, auditors approved accounts that are not a true reflection of the real accounts of the relevant company. *"It is sad to say that professionals in this country have failed the people of this country*," he said, adding that most often he had *"wondered why there weren't relevant notes or adequate disclosures for some accounts".*

The problem that was highlighted by Minister Wickramaratne is not only applicable to public institutions, but private companies as well. It is also not a Sri Lankan problem, but an international problem. Professional accountants and auditors world-over are giving *'opinions'* about the state of affairs of an organisation that have no counterparts in commercial reality, often hiding behind an international accounting standard that has no relevance in the business environment of the country in which the business operates in.

Here is a case in point.

Recently, I attended the Annual General Meeting of a private company in Colombo. This company had purchased a sizable amount of land in the heart of Colombo about 100 years ago for approximately AUD1,000; and built a factory spanning the entire area. (I am disguising the numbers and dates, but the essence of my case is factual). About 10 years ago the company moved the factory out of Colombo; and cleared the land. Then, it utilised about 20 per cent of the land to build a showroom. The showroom construction cost approximately AUD 100,000. The land on which it was built, inclusive of the vacant area was worth about AUD 10 million by then, but was still recorded in the accounts at the original value of AUD1,000. Today, the 80 per cent spare land can be easily sold to a developer and is conservatively worth about AUD 30 million!

Therefore, the value of the company that was being reported to its shareholders was understated by about 30 million Australian dollars! And the auditors, who are essentially appointed by the shareholders to look after their interests, were happily agreeing to this ridiculously fictitious number!

I raised this valuation discrepancy at the AGM and was told that the company has opted to use the cost option to value the land. Following my pressing the issue with the Company Secretary as to how the Auditors (a Big 4 Audit firm – which I will name as the Big 4a Firm) could have given a 'True and Fair' opinion of accounts that are so obviously understated, The Company Secretary obtained this opinion from the Audit partner:

"The property plant and equipment of the company are measured at cost based on the company's accounting policy, which is mentioned in the note number 3.4.1 to the financial statements. This is in

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line with LKAS 16, Property plant and equipment. Please see paragraph 29 of LKAS 16 which gives an entity the option to choose either cost model or the Fair value model. Accordingly company's policy is the cost model." (Junior Audit Partner, Big 4a Firm)

Not being happy with this response, in which essentially the 'form' is given precedence over the 'substance', I asked the Chief Partner of the Big 4a Firm, for a opinion on this specific case. This was specifically with regards to the *International Financial Reporting Standard* on *Fair Value Accounting (IFRS 13*) that the auditor stated was used when giving its opinion on the state of affairs of this particular company.

The Big 4a Chief Partner's response was that IFRS 13 only specifies the methodology to be used when fair valuing an asset. It does not he stated, specifically require any asset to be fair valued - such requirements are specified by the relevant standards. He also stated that:

In the case of the land, the company has opted to use the cost option as opposed to the revaluation option; as IAS 16 permits a company to use either of the options. Had the company opted to use the revaluation option, then IFRS 13 would have come into play.

For the informed reader, the *Sri Lankan Accounting Standard* (*LKAS 16)* is for all intents and purposes a carbon copy of the *International Accounting Standard* (*IAS 16)* and pertains to the valuation of *Property, Plant and Equipment (PPE).* IAS 16 allows the company itself (rather than the auditors) to determine the value of its PPE based on cost or market value.

The Big 4a Chief Partner agreed, however, that the land is very valuable and stated that if the company wishes to switch to the revaluation model in the future, then the surplus on revaluation will be routed through equity as a revaluation reserve.

The Big 4a Chief Partner's reference to IAS 16 prompted this follow-up query from me:

I agree that the company has a choice. But does this not depend on 'recognition date'? As per the standard (IAS 16), the cost of an item of property, plant and equipment is the cash price equivalent at the 'recognition date'. If the old factory still remained at the property, then the recognition date could be argued to be the cost incurred to purchase the land and build the factory in the 1910s. However, as the factory was demolished and the land cleared and a part used to construct an office and showroom; the asset is quite different now; and therefore should not there be a new "recognition date" that comprises of (1) the cleared land valued at fair market value, plus (2) the cost of clearance; plus (3) the cost of constructing the new building?

The Big 4a Chief Partner's response was that:

"The asset, i.e. the land, remains the same; only thing different is the use to which it is put to. This doesn't change the recognition date of the land, which will remain as the date when it was first recognised in the books of the company.

Clearly The Big 4a Firm and its partners were placing the 'legal form' over 'economic substance' in their opinions.

I then asked the Chief Partner of ***another*** Big 4 firm in Sri Lanka (which I will name as the Big 4b Firm) for a view giving him only the facts of the case as shown earlier. His views were more objective:

Whilst IAS 16 allows the company to opt for the cost model in the case of PPE, another standard, IAS 40 pertaining to Investment Property is more relevant for the vacant land. Even though only 20 pc of the land space is used for business purposes, the PPE standard has been used by the company on all

of the land. It could be argued, however, that IAS 40 is more relevant to the 80pc vacant land; and IAS 40 requires the fair value to be disclosed if the cost model is used (Chief Partner of Big 4b Firm).

Clearly, there was a clash of accounting standards and unclear definitions as to if the asset being valued was Property, Plant and Equipment or Investment Property. A company may claim that an asset is PPE one year, and then go and sell the vacant land the next year without any wrongful disclosure consequences.

Despite all these issues as to the definitions of assets and as to which international accounting standards to use; there is an overriding requirement for auditors to give a "true and fair' view as to the state of affairs of the company to the shareholders. The Chief Partner of the second Big 4 firm had this to say:

It would be difficult for accounts to present a true and fair view if form had overridden substance. IAS 8 states that for information to be reliable, it must be reported in accordance with economic substance, rather than strictly in adherence to its legal form. Indeed if material transactions are not accounted for in accordance with their substance it is doubtful whether the accounts present a true and fair view (Chief Partner of Big 4b Firm)..

This is more in line with what the Sri Lankan Deputy Minister Eran Wickramaratne required in terms of the 'professionalism of accountants. Clearly giving a True and Fair opinion just because it complies with the accounting standards is a case where auditors cannot see the forest (big picture) because of the trees (detail).

True and Fair is not something that is merely a separate add-on to accounting standards. Rather the whole essence of standards is to provide for recognition, measurement, presentation and disclosure for specific aspects of financial reporting in a way that reflects economic reality and hence that provides a true and fair view.

The Financial Reporting Council (UK) in a 2014 report on the subject of *True and Fair* gives the following guidelines to preparers of accounts and those charged with governance and audit:

- Always to stand back and ensure that the accounts as a whole do give a true and fair view;
- To provide additional disclosures when compliance with an accounting standard is insufficient to present a true and fair view;
- To use the true and fair override where compliance with the standards does not result in the presentation of a true and fair view; and
- To ensure that the consideration they give to these matters is evident in their deliberations and documentation.

The Financial Reporting Council states that this will help ensure that accounts in the UK continue to demonstrate the high quality that users have come to expect. *This should be no different world-over for both public and private institutions.*

The Chartered Accountants and CPAs should ensure that auditing opinions are not merely given for the payment of an audit fee, but reflect the true and fair state of affairs of an organisation.

Also accounting professional bodies in developing countries should resist this 'new colonialism'; i.e. the colonisation by Western interests - not with guns; but by forcing us to apply international (Western) accounting standards in quite different business environments.