AUDITORS FOR NEW INDIA

CEPR

Dashamlav Advisors

A REPORT BY CENTRE FOR ECONOMIC & POLICY RESEARCH

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ABSTRACT

Macro- economic environment is creating multiple challenges for the Industry in India. This is further getting aggravated by the narrative which has got built up around the Audit Profession in the country.

Availability of trustworthy financial information on the performance of companies is important to proper functioning of market economy. In the present times, wherein the questions get raised around the integrity of the Auditors in carrying out their duties, it has the potential to take down the whole system by putting it in a precarious situation.

The independent audits are fundamental to taking informed and correct investment decisions. This requires preparation and presentation of intense financial statement by the management and the board of directors. It is critical that each key element, who is part of this ecosystem, is both empowered and accountable.

It is important to facilitate a business-friendly environment for corporates as well as Audit professionals in India. Therefore, it is vital that Indian laws and regulations on audit and assurance professional services keep pace with changing market dynamics.

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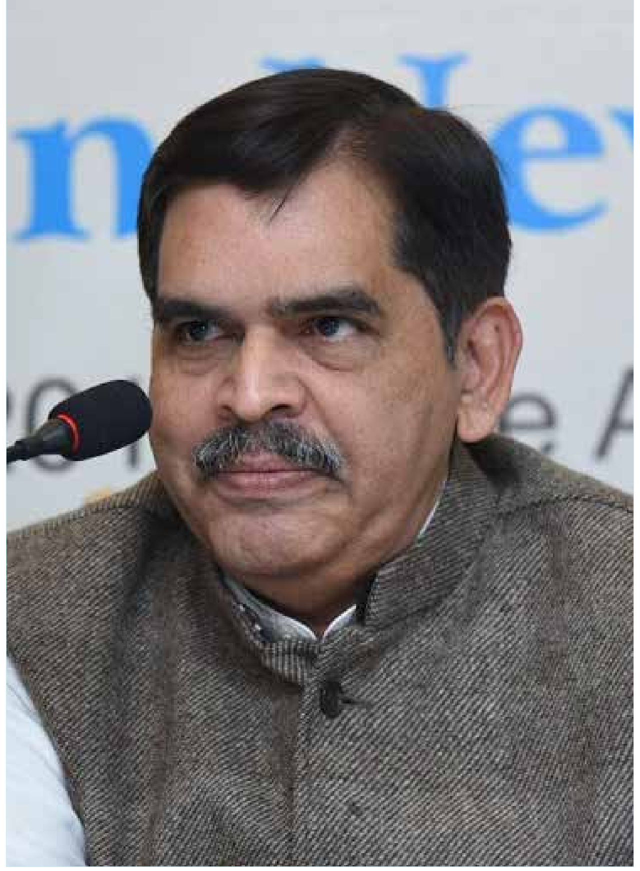

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INTRODUCTION

It's **our Prime Minister's** vision to make India a Five Trillion Dollar economy by 2024, which is market oriented and is a just place for the investors. To make it happen, the audit profession has a critical role to bring the much-desired transparency and build confidence of the investors.

The objective of audit of financial statements by an independent auditor is the expression of opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

The auditors in their reports are required to disclose whether to the best of his information and knowledge, the said financial statements, give a true and fair view of the state of company's affairs as at the end of its financial year and profit or loss and cash flow for the year. In order to form that opinion, the auditor has to conclude as to whether he has obtained 'reasonable assurance' regarding the financial statements as a whole being free from material misstatement, whether due to fraud or error. He has to ensure that the company has adequate internal financial controls with reference to financial statements in place and such controls are the operating effectiveness.

In order to form that opinion, the auditor has to conclude as to whether he has obtained reasonable assurance regarding the financial statements as a whole being free from material misstatement, whether due to fraud or professional error in judgement.

However, recently, there is an impression that the auditors are expected to be more vigilant and like a watchdog look for the information and be suspicious of every transaction and hunt for frauds, 'if any'. This is forcing the corporate houses to shift their focus from doing the business to justifying every transaction.

The auditors are bound to follow the accounting standards, or SA. The SA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing defines reasonable assurance, in the context of examining the financial statements, is a high, but not absolute. It underscores the inherent limitation of the professionals. He might not be in position to determine, whether the financial statements as a whole are free from material misstatement, whether due to fraud or a bonafide error. Most of the audit evidences on which the auditor draws conclusions and bases the auditor's opinion are persuasive rather than conclusive.

The inherent limitations of an audit arise from nature of financial reporting (e.g., use of accounting estimates), nature of audit procedures (e.g., ineffective audit evidence in case of fraud) and need for the audit to be conducted within a reasonable period of time and at a reasonable cost, recognising that it is impracticable to address all information that may exist or to pursue every matter exhaustively on the assumption that information is in error or fraudulent. Because of the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with SAs.

Accordingly, the subsequent discovery of a material misstatement of the financial statements resulting from fraud or error does not by itself indicate a failure to conduct an audit in accordance with SAs.

If we put together the dots gathered after the revelations of recent corporate frauds. The biggest challenge audit profession faces is of credibility. It is is critical not only to restore this confidence amongst the larger stakeholder's group in the eco system but also to enhance the same going forward.

KEY ISSUES

- **AUDIT COMMITTEE,** ITS ROLE AND AUDITORS POSITION
- **FIXING** THE LIABILITY
- **NEED** FOR AN AUDITING REGULATOR
- **MDPS**-MULTI-DISCIPLINARY PRACTICES

Audit Committee, Its Role and Auditors Position

The audit committee, management, and the independent auditor all have distinct roles in the financial reporting process. The Audit Committee's primary function is to oversee the financial reporting and related internal controls.

Management is responsible for preparing the financial statements, establishing and maintaining adequate internal control over financial reporting and evaluating its effectiveness.

The independent auditor is responsible for expressing an opinion on the fairness with which the financial statements present, in all material respects, the financial position, the results of operations, and cash flows in conformity with the accounting principles.

The audit committee should be familiar with the processes and controls the management has put in place and understand whether those processes and controls are designed and operating effectively. The audit committee should work with management, the internal auditors, and the independent auditors to gain the knowledge needed to provide appropriate oversight of this area. Likewise, the audit committee is responsible for overseeing the entire financial reporting process. To do so effectively, it should be familiar with the processes and controls that management has established and determine whether they were designed effectively.

There is a need to clearly define the responsibility and accountability that both – the Audit Committee and the Auditors carry. The management to all fairness do expect the auditors to catch loopholes. But it becomes almost impossible to detect many of them especially with the limited scope and undefined area of work and powers.

In these circumstances, it becomes unfair to blame only auditors for the challenges that may occur pertaining to financial reporting. Ways and means to improve the role of the audit committee and make it more involved and responsible has to be explored. Being one of the most important committees of the Board, its role cannot be limited to post-facto analysis and fire-fighting, as is the case at present.

Fixing the liability

It is important to facilitate a business-friendly environment for corporate as well as professionals in India. Therefore, it is critical that the laws and regulations on professional services keep pace with the changing market dynamics.

The Independence of auditor and non- existence of the conflict of interest has to be ensured in the entire process of audit and other services provided by the auditors to the same corporate.

The Liability mechanism for auditors is an area that needs to be duly addressed. The actions are being taken against auditors even in before proven guilty.

It will keep high-quality talent away from the profession and create an atmosphere of fear, triggering a spate of resignations by auditors, impacting investors and leading to further compromise of the compliances.

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Need for an Auditing Regulator

Time and again corporate scandals and accounting frauds have nudged Institutional reforms across jurisdictions. One such fundamental reform that has happened globally in the last two decades is a shift away from the Self-Regulatory Organisation (SRO) model towards an independent regulatory structure for the audit profession.

Satyam incident has been a wake-up call for policy- makers. Pursuant to the global trend of shift from SRO model to an independent regulatory model for audit profession, the Companies Act, 2013 provided for the setting up of the National Financial Reporting Authority (NFRA). But the entity came into existence in November 2018, after it took nearly five years to notify the body.

Regulatory overdrive with multiplicity of regulators is putting tremendous pressure on the audit profession.

Whenever an accounting transgression takes place, regulators pass regulation as a kneejerk reaction. The role of regulators is not only policing the audit firms but also working towards the development of the profession.

However, the delay in setting up of the NFRA has already pushed back several critical reforms. The regulator must be equipped to handle the contemporary challenges in relation to auditors and audit firms. It is imperative that the body auditing the Auditors is formed with legal and technical people from the profession to evaluate the professional's work.

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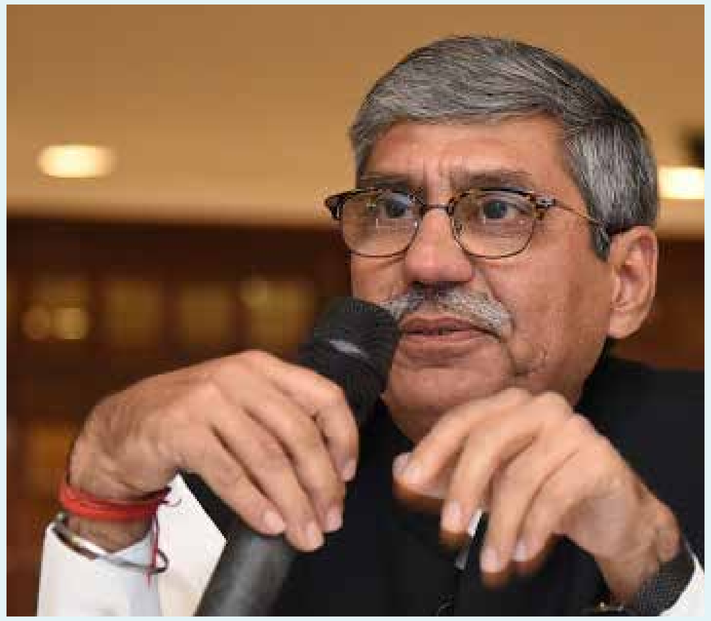

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MDPs- Multi-Disciplinary Practices (MDPs)

Topical issue needing attention is that of MDPs. As claimed does it enhance the standards of services offered to corporate houses along with getting more insights for the investors to take better investment decisions?

Does rendering the non-audit services help these firms gain insights into the company's business and operations? Is an auditor with this insight in a better position to advice on the compliances as well?

How should the audit firms address the challenges of Conflict of interest and Integrity arising due to MDP? It is equally critical to have the view point of the corporate and investors on this issue of MDPs as they are critical stakeholders in the value chain. The section 144 of the Companies Act, 2013 prohibited certain services to be provided by the auditors of the company.

RECOMMENDATIONS/ KEY TAKEAWAYS

- **ROLE OF TECHNOLOGY** IN AUDIT
- **CAPACITY** BUILDING FOR AUDITORS
- **APPOINTMENT PROCESS** FOR AUDITORS
- **FEES** STRUCTURES
- **NFRA'S** ROLE
- **LIABILITY** MECHANISM

Role of Technology in audit

The business in present times is becoming larger and more complex. It is becoming difficult for the auditor to really access the complete data and study the systems to achieve the in-depth examination and subsequent analysis. The limited tools to access and analyse the data and study the systems to bring out effective reports is becoming a big challenge and these limitations are across both the large and small enterprises.

The latest advances in technology promise significant benefits for the audit profession, with a number of key drivers signalling the need for technological change in audit. Such drivers include the rapid increase in volume of data, changes in business models, the shift towards automation and the demand for a proactive and forward-looking approach to audit. These developments require auditors to be technologically sound to enable them to execute high quality audits.

The volume of transactions and data in businesses has increased dramatically since 2016 and is expected to keep increasing in the future. It has been estimated that over 90 percent of the world's data has been generated since 2016, and significant amounts of it are financial data (March 2018). This rapid increase in the volume of data requires auditors to be equipped with the latest available technological tools to analyse a much higher volume of data in their audits than previously required.

Systemic Audits are also emerging as a pre-requisite to any assurances an audit can give,

RAJAN DOGRA
Former Independent Director, Vijaya Bank

further giving rise to the instant need for the Auditors to equip themselves with relevant knowledge of technology to do their assignments effectively and efficiently. Updating of this knowledge which is a continuously process is also the need of the day and poses a constant challenge.

Businesses across almost every industry are in the front line, experiencing at first hand the disruptive changes that are also affecting their auditors. Disruptive change needs to be distinguished from innovation and technology per se: the key to disruption is that it creates innovation in business models, new ways of working in markets and new sources of value. Disruption can be enabled by technology but need not involve technological breakthroughs: it can involve simply putting existing technologies together in a new way.

Such technological changes in businesses and their business models require the attention of auditors of any size including small and medium-sized practices (SMPs). For example, start-up businesses now tend to have business models based on advanced technologies. Complex audit challenges could therefore come from smaller businesses too.

The most immediate impact of technology on the profession is in the automation or even elimination of manual and routine tasks. This movement is accelerated because it has multiple drivers. The shift to cloud-based accounting systems and the attendant standardisation of processes has made data more easily and more widely available, easier to move between systems, easier to manipulate and analyse, and less prone to corruption and errors.

Despite this, there seems to be little appetite for 'human-free' audit – automation can reduce errors and spot patterns, but that merely provides the opportunity for individuals to exercise thought and judgement, and to bring into play other skills such as communication, persuasion and empathy. Auditors may find they are asked to look into fewer anomalies – but these will be the ones that count. It seems that the role of the auditor as filter, narrator and independent challenging voice remains secure.

The use of advanced technologies and data analytics promises a transformation in the audit profession, changing audit from a reactive and backward-looking exercise to a proactive, constant source of forward-looking insights that can be used all the time, with the auditor as the custodian and interpreter of the underlying data foundation. Even in its traditional context, technology now offers an opportunity to produce higher-quality audits that better serve for their existing purpose.

Capacity Building for Auditors

The auditors' capacity is building up, yet it is far from what the developed countries already have. To compare, China has 42 lakh companies, while India has over 11 lakh companies out of which over 7000 are listed while in China approximately 3000 of them are listed. To build up their books the neighbouring country China has only 9000 auditors while India has over 67,000 auditors out of which 47,000 are sole proprietorship firms.

There is an imminent need to build capacity of India's auditors so that they can carry out audits of the large organizations. It calls for consolidation that should take place in the Indian context as there are 50 firms in India which have more than 20 partners. There is need to build up more capabilities, more transparent and encouraging mechanism to share knowledge and extend cooperation.

The CA professionals are assisting the corporates in fulfilling their compliance obligations under various laws more specifically under direct and indirect taxes. Capacity building of professionals (not auditors) for compliances is of equal importance to bring higher level of compliance.

To encourage capacity building of auditors, the appointment of joint auditors from the domestic audit firms can also be implemented. It must be complemented with the implementation of the rotation of auditors in letter and spirit.

Appointment of auditors

Appointment of auditors has been subject of topical discussion triggered on account of recent alleged audit lapses creating doubt in the minds of stakeholders regarding the independence of auditors.

India's focus is on establishing a high-quality capital market to attract investments; shareholders and investors must have a free choice to appoint auditors, which is fundamental to Ease of Doing Business in India.

Shareholders should be free to choose the auditor that fits their criteria of size, service quality, audit methodology and tools. The corporations should look to appoint audit firms because of one's higher service quality and bandwidth. This become more relevant in case of specialised industries (such as financial sector, telecom, power, etc.) where there is low availability of auditors with sufficient expertise and capability and where audits require extensive use of experts such as IT specialists, actuaries, valuators etc.

The global experience shows that in all major geographies including BRICS nations, EU nations, UK, USA, China, Japan, Singapore, Australia, BIMSTEC nations, shareholders have similar rights to appoint company's auditor.

Thus, the appointment of auditors is the apex right of the company's shareholders and it should remain with them as it is the shareholders who are the real owners of the company.

Simultaneously, there shall be efforts made to increase the choice of auditors, provided that such measures would not impair audit quality or erode the responsibility of audit committees to appoint the auditor and oversee the audit process.

Fees structures

The auditors play a vital role in upholding the corporate governance standards in India. The external auditors are responsible for independently reviewing the financial statements of companies and provide opinion regarding its truthfulness and fairness.

The external auditors ensure that the regulators and investors maintain their faith in the functioning of the companies. The Indian companies have grown at a fast rate in the twenty first century both through mergers and acquisitions route as well as by product and geographical diversification. As businesses become large and complex; the job of the auditors becomes even more challenging. With rise in business complexity, the auditors also need to upgrade their knowledge spectrum in order to justify their role as independent monitors. It is likely that as audit assignment becomes more complex the auditors charge a higher fee for rendering their services.

However, the companies pay a lower audit fee in spite of business complexities indicating that the Indian market for auditor's remuneration is driven by the market power of the clients to a large extent.

NFRA's Role

NFRA though at a very nascent stage as an organisation, with some predefined thresh hold of the companies that can be taken up by it, while the rest continues with ICAI with capacities nicely divided. Both ICAI and NFRA can work together and combine their capacities to do a very harmonious work.

NFRA as an independent audit regulator is expected to enhance investor's confidence and bring more transparency and accountability in the auditing profession. With the roles and responsibilities extending to even employees of the audit firms, they need to be wary of their accountability in the audit firms. Although the NFRA is mandated to not publish proprietary or confidential information, however, at the same time, it is given the power to do so in the public interest if it has reasons for the same. It is a power that will need to be exercised with great caution.

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Independent Director, Union Bank of India

With more complex and multi-layered structures and increased corporate governance, it will be interesting to see the implementation and effectiveness of the NFRA vis-à-vis the increased roles and responsibilities of auditors, and whether the NFRA will be able to act as the watchdog to protect the public interest and the interests of investors, creditors and others associated with the companies or bodies corporate falling within its purview.

It is important to build the independence for NFRA, it continues to be the regulatory agency for the larger organisations. More critical is that how NFRA can contribute towards building the capacity for the profession as a whole with the global practices.

Therefore, if the regulator is at a nascent stage, then they must seek help. There are organizations who are ready to provide that support, so there are larger organizations who are ready to support in term of the audit quality in the overall interest of the audit profession.

NFRA should play the role of what regulators do internationally, to do inspections, share those finding of inspections, with a clear focus on how audit quality should be strengthened.

The International Forum of Independent Audit Regulators (IFIAR) is an organization with several countries as its members. NFRA should be a part of it to understand the global best practices so that they can undertake the inspections in a qualitative manner, appreciating that not everything is construed as a fraud.

Liability Mechanism

Liability mechanism for auditors is an area that needs to be duly addressed. Drastic actions are being taken against auditors even in the absence of being proven guilty.

The increased 'unregulated' regulatory pressure is leading to high-quality talent moving away from the profession. And it is creating an atmosphere of fear, triggering a spate of resignations by auditors, impacting investors' big time.

Another trend witnessed in the last few years is on the consistent reduction in the number of new students' registration with the ICAI due to the excessive regulatory actions.

There is a need to strengthen the powers of NFRA to avoid multiplicity of regulators governing the auditors and audit profession.

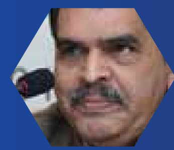
It was suggested that the investigation or inspection should be based on a clearly defined framework i.e. NFRA should assess auditor's professional misconduct in accordance with NFRA rules. The auditor should be given an adequate opportunity of being heard and present all the facts before deciding on the penalties. Criminal or civil negligence implication should be assessed based on the conclusions reached by NFRA.

It was also suggested that while levying a particular quantum of penalty, the levying authority shall also take into consideration factors such as injury to public interest, nature & gravity of default, repetition of default.

The debarment of an audit firm must be done in the cases the firm refuses to co-operate or its management is involved in the fraud.

The Committee should review the offences and penalties on the auditor to differentiate between criminal and civil liabilities. There is an urgent need to provide for a regime of penal provisions in commensurate with the offence. ◆

PROMINENT SPEAKERS



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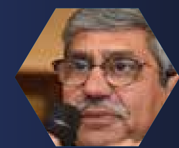

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