



# CIO Dialogue

## with Auditors

in partnership with



**IiAS** FOUNDATION  
**INSTITUTIONAL  
INVESTOR  
ADVISORY SERVICES**



## CIO Dialogue with Auditors

### Background

The audit world, especially the Big Four, are under fire from the regulators. Securities and Exchange Board of India banned PwC in 2018 from auditing listed companies for two years. Securities Appellate Tribunal has quashed the ban and SEBI has challenged the decision. In June 2019, the Reserve Bank of India barred SR Batliboi & Company, an affiliate of EY, from carrying out statutory audit assignments of commercial banks for one year. The Serious Fraud Investigation Office (SFIO) has charged Deloitte Haskins & Sells and BSR and Associates (part of the KMPG network), for their failure in not disclosing the true financial health of IL&FS Financial Services and are looking at banning them from undertaking audits.

Add to this, divergences and the frequent resignation of auditors, there are doubts on the quality of the audits that is being presented to investors. How does one bridge the trust deficit between audit firms and investors? And if the big four firms are 'banned,' where does it leave companies and importantly investors?

National Stock Exchange (NSE) and Institutional Investor Advisory Services (IiAS) collaborated to host a roundtable, on 9 August 2019, between audit firms (the big four and some domestic firms) and some institutional investors regarding the issues facing the audit industry and the ramifications of these for both auditors and investors.

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## Restoring public faith in auditors

Auditors are considered market fiduciaries, because they validate the fairness of financial statements. Resignation of auditors and frequent changes in auditors are considered early warning signals by most investors. The market frustration over the lack of accountability of the audit industry led to SEBI using its discretionary powers over market fiduciaries to regulate auditors. SAT overturning SEBI's ban of PriceWaterhouse, legally tenable no doubt, misreads market expectations and leaves open the question of their accountability yet again. There needs to be a systemic focus on improving audit quality standards.



### The expectations gap

The market has been raising pertinent questions over auditors given the recent controversies. IL&FS, CG Power and Industrial Solutions Limited, and Dewan Housing Finance Limited (DHFL) are just some of these instances. In these and in others as well, investors question the role of auditors in not being able to highlight financial shenanigans, which (post-facto) seemed obvious in some cases. Another frequent comment from investors is that audit reports are scripted, and most read similar to each other. Put differently, it is that audit reports don't really differentiate between companies.

The audit industry argues that the failures are isolated instances and that in aggregate, these 'mishaps' account for a very small share of the financial statements reviews by auditors. This no longer appears to hold. The financial implications of these 'mishaps' has been material starting from the Satyam fiasco — the first material event that raised questions on the role of the auditors — to IL&FS, to Vakrangee, to DHFL, to Fortis, to CG Power and to several more. These have impacted both banks and the average citizen: either through an overall impact on the economy or through the erosion of personal wealth.

In most instances, investors seemed to *sense* that something is amiss, well before an auditor raised red flags. This has been reflected in either a steadfast deterioration in the company's stock price, or a systematic contraction in the company's access to debt. Therefore, if the 'market knows' based on largely publicly available information, why are auditors - who have access to much better quality of internal information - unable to see the writing on the wall? Can what the 'market knows' be embedded into the audit process?

One of the questions raised during the round table was whether audit firms did a 'look-back' to see what they missed in being unable to catch these failures. The firms reiterated the claim that they have strong processes in place that ensure appropriate level of oversight of each individual audit. This includes measuring partner hours per audit, monitoring of workload of the audit team, use of technology to scan through reams of data, leveraging the forensic practice to examine critical areas, a committee-based escalation matrix for tricky issues (this is essential as more judgement-based accounting seeps into the financial statements) and internal independent reviews on quality of work.

If this is indeed the case and audit review processes are strong, the answer may be that auditors have limited themselves to form, rather than the substance in audit reports.



Auditors describe their role as expressing an opinion on the financial statements, whose preparation is the responsibility of the management. In expressing this opinion, they appear to limit their role to what is prescribed by the accounting and auditing standards. If so, there still exists one contradiction. If Indian accounting standards are closer to International Financial Reporting Standards (IFRS), why is there so little confidence that they offer a truer picture.



### Regulatory oversight

Can the answer lie in tighter enforcement? The dominant regulator for the audit industry, until recently, was the Institute of Chartered Accountants (ICAI), which did little to promote better industry standards. ICAI's Quality Review Board (QRB), which is responsible for the review of audit quality, has reviewed just 580 audit engagements over six years between 2012-2018, of which it found only 39% to be of generally accepted standards. Despite the abysmally low volume of reviews, the results are reflective of what the market experiences. Less than half the audits are of acceptable quality. Even so, there has been no sense of urgency in ICAI's effort to raise audit standards. The creation of the National Financial Regulatory Authority (NFRA) is possibly the next hope for imposing accountability within the audit industry.

It is this market frustration over the weak regulatory oversight that has led different bodies usurping oversight on the audit industry. The accountability of auditors was first enshrined in the Companies Act 2013, which brought penalty provisions for auditors. RBI banned an audit firm from auditing banks, which is well within RBI's purview, since all bank auditors need to be approved by RBI. SEBI decided to use its discretionary powers over market fiduciaries to ban PriceWaterhouse in the Satyam case. In expecting SEBI to establish criminal culpability of auditors before exercising its oversight powers, SAT has done a disservice to investors and misread market expectations. The market has been itching for SEBI to take a stand on auditors.

The market regulator unfortunately both, dithered and overreached in holding the auditor accountable. The decision came a decade after the event, during which time the people running the audit firm, and the practices that the firm followed had changed materially. And while SEBI had certainly done its homework on the responsibilities of the auditors, it should have accounted for a more graded punishment mechanism – simply banning the entire firm, at this late stage, was perhaps a stretch.



### **Issues of conflict**

This is also the best time for the industry to question if there is a conflict of interest for partners: at times incentives are linked to revenues. While at a leadership level it may be difficult to separate revenue targets as performance criteria, perhaps at the operating level separation of business targets and audit quality needs to be administered. Rating agencies and even proxy firms have separated business and analytical targets – the audit industry needs to quickly take heed.

### **Capability beyond the big four**

With all the 'Big Four' audit firms are grappling with regulatory action, each for a different reason, the other looming question for the markets is whether domestic firms (not affiliated to international networks) have the capacity and the capability of conducting audits of large listed companies. This question is central to the debate, as accounting moves towards becoming more judgement-based, for which wide-spread institutional experience and memory are needed.

Domestic firms are confident of their capacity and foreign audit firms re-emphasise their quality. Although both sets believe that that capacity and capability of audit firms are fit for purpose, the lingering doubt continues in the minds of audit committees and investors. Market confidence needs to be restored.

### Auditor resignations

Auditor resignation has worried investors. More so, if auditors resign during the year, before signing off on the year's financial statements. In several instances, following the appointment of a new audit firms, adverse remarks made by the outgoing auditor (in quarterly statements) have quietly disappeared and a clean audit report has been issued by the newly appointed auditor.

Auditors argue that resignations are not that uncommon – it wasn't noticed earlier because of the annual appointment of statutory auditors. With five-year terms, the resignations appear more pronounced -earlier they just did not get themselves re-appointed. Even so, the concern over auditor resignation was important enough for SEBI to publish a circular on [Resignation of statutory auditors from listed companies and their material subsidiaries](#). The circular does not allow auditors to simply walk away – it encourages audit firms to either complete the audit or publish a disclaimed opinion. While this will likely increase the discord between warring managements and audit firms, it may well be in the interest of all stakeholders.



### Looking ahead

The creation of an ecosystem that compels better audit quality is a possible solution. There needs to be an industry-level focus on strengthening audit quality – one that does not ignore what the market already seems to know. Leaving it alone to regulatory bodies is not enough. There needs to be a systemic solution, which begins with audit committees being discerning in setting audit quality metrics (Exhibit 1) that audit firms need to meet before being engaged as statutory auditors. Audit committees need to annually test for auditor independence, as well have sufficient expertise to challenge auditors – rather than learn from them. Audit firms too, must publish audit quality metrics for their firms; this is a practice is followed in global markets. Creating transparent metrics for measurement of audit quality and compelling their disclosure will perhaps be a big step in setting accountability.

### Exhibit 1: IiAS Audit Quality Indicators

Audit quality is difficult to assess in its absolute terms, but there are indicators that can reduce the subjectivity involved in evaluating audit quality. Audit Quality Indicators (AQIs) are a set of qualitative and quantitative parameters to provide a basis for comparison across different audits and audit firms. AQIs can be defined at both engagement level (indicators related to the specific audit engagement) and audit firm level (indicators to gauge the audit firm's overall focus on quality).

Globally, several initiatives have been taken to outline such measures. For India, IiAS recommends the following metrics:

**Workforce metrics:** These set of indicators enable the audit committee to judge the knowledge and experience levels of the audit firm personnel.

**Training:** These metrics can be used to check the efforts undertaken by the audit firm towards skill-development and training of its audit team.

**Quality:** These indicators highlight the quality of audit process and instances of audit deficiencies.

**Trends in audit metrics:** These metrics may help the audit committee understand if fees and time involvement have grown in proportion to the complexity and volume of audit work.

**Legal:** These indicators highlight the instances of litigation and penalties imposed by regulatory bodies on the audit firm.

**Independence:** These indicators can be used to evaluate the independence of the audit team and steps taken by the audit firm in ensuring that the independence policy is not violated.

**Technology:** These metrics indicate how well the audit firm understands the technology being used by the audit client, and leverages technology and analytics in audit execution.

For more details on IiAS Audit Quality Indicators for India, please see "Auditing the Auditors: Audit Quality Indicators" available here: <https://bit.ly/2Wb3BOD>

For the list of participants at the roundtable, please write to [solutions@iias.in](mailto:solutions@iias.in)

## **About NSE**

The National Stock Exchange of India Ltd. (NSE) is the leading stock exchange in India and the second largest in the world by nos. of trades in equity shares from January to June 2018, according to World Federation of Exchanges (WFE) report.

NSE has a fully integrated business model comprising our exchange listings, trading services, clearing and settlement services, indices, market data feeds, technology solutions and financial education offerings. NSE also oversees compliance by trading and clearing members and listed companies with the rules and regulations of the exchange.

## **About Tata Investment Corporation Limited**

Tata Investment Corporation Limited is a non-banking financial company. The company is primarily involved in investing in long-term investments such as equity shares and equity-related securities.

Tata Investment Corporation Limited was promoted by Tata Sons Ltd., in 1937, under the name The Investment Corporation of India Limited. The Company remained a closely held company till 1959, when it became one of the few publicly held investment companies listed on the Stock Exchange, Mumbai. During the 1960s and 1970s the Company's activities underwent a gradual transformation from assisting in the establishment of new ventures, to acting as an investment company with a diversified portfolio of investments.

## **About IiAS Foundation**

The IiAS Foundation has been established by IiAS to serve as a platform for market participants i.e. business leaders, board members, academics, investors, issuers and intermediaries to interact on the practice of corporate governance and there to approach to ESG. It aims and to foster debate around regulations, corporate and investor behaviour and capital markets

## **About IiAS**

Institutional Investor Advisory Services India Limited (IiAS) is an advisory firm, dedicated to providing participants in the Indian market with independent opinions, research and data on corporate governance issues as well as voting recommendations on shareholder resolutions for ~ 800 companies that account for over 95% of market capitalization. IiAS is a SEBI registered research entity (proxy advisor registration number: INH000000024).

IiAS has equity participation by Aditya Birla Sunlife AMC Limited, Axis Bank Limited, Fitch Group Inc., HDFC Investment Corporation Limited, ICICI Prudential Life Insurance, Kotak Mahindra Bank Limited, RBL Bank Limited, Tata Investment Corporation Limited, UTI Asset Management Company Limited and Yes Bank Limited.





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