Raising the bar for auditors

The MCA's proposal to curb non-audit services will affect small firms, while any move to cap the number of clients of large audit firms will hurt investment, say experts

GEETIKA SRIVASTAVA & SUDIPTO DEY

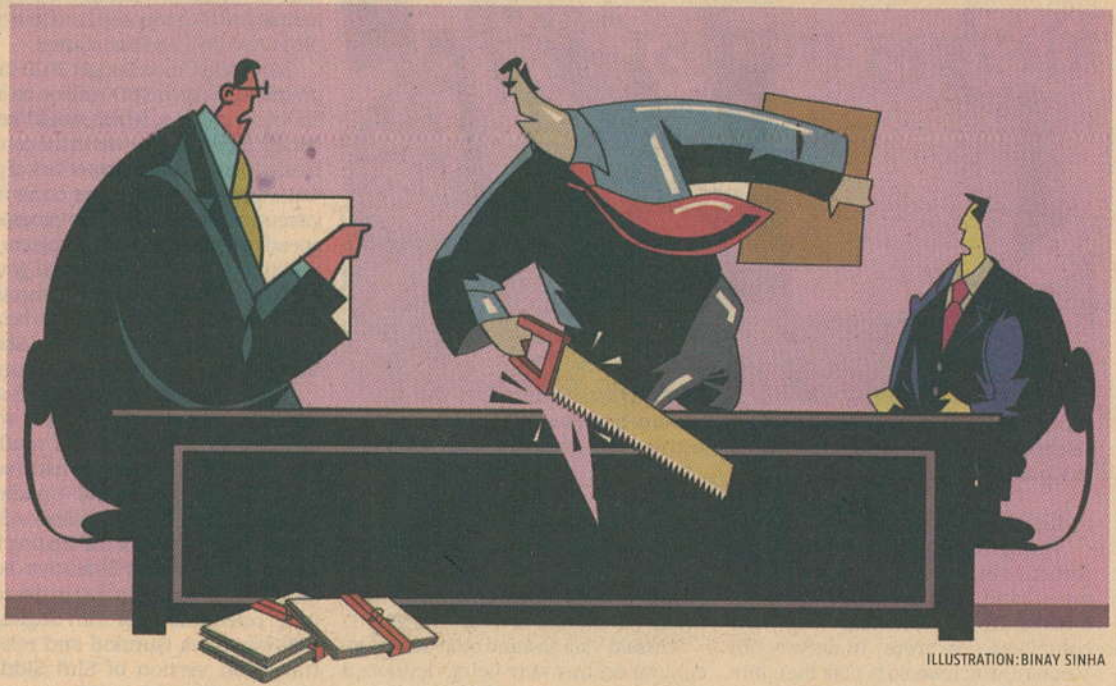

ILLUSTRATION: BINAY SINHA

Earlier this month, Institute of Chartered Accountants of India (ICAI), the self-regulatory body for audit profession, had its 70th Annual Day bash at a five-star hotel in Delhi which was attended by hundreds of its members and students from across the country. But what cast a shadow on the gathering was a consultation paper — recently released by the ministry of corporate affairs (MCA) — which raised questions over the independence and accountability of auditors.

Several experts over the years have suggested measures to raise the accountability bar. This time, the consultation paper drives that point hard: "Recently, various instances of failure of auditors have been noticed, such as (in the) IL&FS case, and it also has been seen that the quality of audit reports have been compromised. In most of the cases, the auditor appears to be hand in glove with the management and, therefore, the question on their independence and accountability have been arisen."

"What is worrisome is the tone of the consultation paper. The language is accusatory," says a senior executive from one of the Big 4 audit firms.

Welcoming the MCA's move, ICAI has appointed a high-level committee to prepare its responses. But, consensus on the recommendations would be difficult for the audit fraternity.

Among several proposals in the discussion paper, two have riled both big and small players offering audit and advisory services. One, putting a cap on the number of clients a 'Big 4' audit firm can take. The other, putting a blanket ban on offering non-audit services to audit clients.

The MCA, through its consultation paper, has highlighted its concerns about the economic concentration of audit work in the domestic market and an "inadequate degree of competition" because of the oligopoly of the Big 4 audit and accounting firms. The paper suggests two ways of combating the situation — one, through putting a cap on the number of audit firms a group can have; two, via fostering growth of domestic audit firms to ease industry's reliance on the Big 4.

Under the present system, an auditor cannot undertake the audit of more than 20 companies. However, large audit firms partner with local firms and license the use of their name to undertake more audits. As a result, over 70 per cent of the firms on the Nifty are audited by firms related to the Big 4, according to PRIME Database. The consultation paper states that because of the aforesaid situation, the quality of the audit becomes "compromised", which may signal the need for putting a cap on the number of audit firms a group may have, and the number of partners in a firm be fixed to a certain limit (to allow better allocation of resources).

While there are concerns in the audit fraternity about the size and influence that the Big 4 wield, the general feeling is that is unfair to punish "size". "To correct the economic concentration, what you need is many large audit firms, and not to make the large firm small," says a former head of one of the Big 4 audit and accounting firms. A cap, if put, could only be a transitory measure, he adds.

One thing most professionals agree on is to incentivise small and mid-sized firms to grow. ICAI, too, is looking upgrade the network guidelines for audit firms so as to encourage small and medium-sized firms to work with each other, and eventually merge, says a senior council member of ICAI. "We want to spread the message that they should move towards an LLP structure."

Many members of the audit fraternity feel the proposal to put a blanket ban on offering non-audit services to audit clients will hit small firms the most. Most proprietorship audit firm package audit services, along with tax advisory services and their client's compliance-related requirements. Taking a cue, two large audit firms — Grant Thornton India and PW India — have decided not to partake in non-attest work with their audit clients. No country but the UK bars offering non-audit services to audit clients.

Sriram S L, corporate lawyer, suggests the MCA should ideally mandate parameters of quality for audits, and even implement a minimum number of employees to be staffed on each audit mandate.

THE CHALLENGES

- **Self-interest threat** because of auditors' reliance on the fees from their clients
- **Self-review affects the** independence of the auditor if he/she is auditing own work or work done by others in the same firm
- **When an auditor promotes the client** to the point in which their objectivity is potentially compromised, resulting in advocacy threat
- **A familiarity threat exists** if the auditor is either too familiar with employees, officers, and directors, or keeps a long-standing relationship with the client
- **An intimidation threat to independency exists** if the auditor is intimidated by management or its directors to the point that they are deterred from acting objectively

Source: MCA's consultation paper to enhance audit independence and accountability