

## IMPROVING AUDIT QUALITY

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### SUMMARY OF DISCUSSIONS

#### Background

*In the recent past, there has been increasing focus on the quality of audit. Audits that have not measured up in the eyes of stakeholders have also been the focus of Regulators, and this has translated to more prescriptive arrangements. While some argue that the occasional audit failure should not lead to sweeping, and often, disruptive changes in regulations, others contend that every failure is an opportunity to learn appropriate lessons, and to put in place various measures to ensure that similar errors and omissions as also transgressions do not take place. The latest effort in tightening regulations is the RBI's guidelines regarding various restrictions sought to be imposed on auditors, and resultantly, on the auditing profession. It is necessary for auditors, preparers and others interested to determine collectively the appropriate framework which while improving audit quality, is not disproportionately restrictive. The desirable objective of enhancing the competence of mid-tier audit firms also needs to be addressed.*

#### DISCUSSIONS

- In 1971-72, the then President of the Institute of Chartered Accountants of India (ICAI) proposed that there should be rotation of auditors, so that opportunities can be created for more auditors. He also proposed that the profession should be nationalised.
- In 1976, a ceiling was introduced with regard to the number of audits that an auditor can undertake.
- The recent circular of RBI, on audit rotation, states that each audit firm should be given a term of 3 years. This time period is very short, and could expose banks and NBFCs to greater risks. The circular would only result in more firms being added to the list of firms auditing banks. For rotation of auditors, the provisions of the Companies Act, 2013 seem appropriate.

#### Approaching the problem of lack of audit quality

- For sustainable improvements in audit quality, it is important to first identify the exact nature of the problem, and the root cause for it, and then decide on the solution, based on what is sought to be achieved.
- Improving audit quality would require determining where we are, and where we want to be.

#### Problem statements

Audit quality is a serious matter, and the substance of audit quality needs to be addressed. It has eroded over the years for various reasons. Some of the possible reasons are –

- The shift from manual auditing to remote auditing. In auditing, the ability of the auditor to see and smell are both important. Earlier, there was manual verification of vouchers etc, and visits to the auditee's offices, which helped the auditor to gauge what was happening in the office. With remote auditing, both the ability to see and to smell have suffered. Remote auditing could at times also result in the auditee playing with numbers.
- Over the years, while joint audit has been thought of to be a solution to some of the problems confronting audit, and for audit quality to improve, a number of scams, such as the Harshad Mehta scam, revealed that joint audit was of limited help in such cases, since all the banks that suffered on account of the scam had joint auditors.

- Monopoly of the Big-4 in the auditing profession is not the real problem. Most professions have monopoly of top players, and this is not restricted to the accounting profession alone.
- The expectations of different stakeholders and the Regulators from the auditing exercise are different.
- In an attempt to taking corrective action to improve audit quality, Regulators often swing to extremes, with the solutions sometimes being worse than the problem.
- Audit quality depends on the purpose that audit seeks to serve. There is a need to change the purpose, since the context has changed. Earlier, the purpose of audit was to “confirm and verify”. At present, there is a need to move away from this, and to move towards the future. There should be a move from hindsight/ insight to foresight.
- There is a shift in culture. Auditing profession has become a business, rather than a profession. Audit quality cannot be addressed by prescribing changes in the manner of appointment of auditors.
- There is no single perception of audit quality in the minds of auditees and other stakeholders. It depends on who looks at it, and from where. There is a need to have a single perception.
- Capacity building, especially in smaller firms, is a problem since most of them do not have the capacity, and sometimes the willingness, to make appropriate investments.
- Reducing compensation of auditors could be counterproductive. There is also a comparison between companies on the audit fee paid. It would be difficult to determine one single figure, that can be decided by the ICAI or the Regulators or any external body as the compensation for audit firms.
- Non-audit fee is often more than the audit fee paid to the auditor. Audit firms also look for other businesses which are more profitable, and this could impact on their independence.
- In a rush to be the first to declare audited results, companies do not give adequate time to the auditors to complete the process properly. This could compromise the quality of audit. Also, as and when a new firm audits the accounts of a company, it would be even more difficult to work under stretched timelines.
- Audit is the collective responsibility of the management, the Internal Audit, the Audit Committee (AC) and the Auditors. To place accountability on one of them, to the exclusion of the others, is not correct. If something were to go wrong, the company and the auditor will both suffer.
- Perception of quality of audit matters. Even if there is a perception that audit is not good, it would impact on the reputation of the auditor and the company.

**Factors to be considered when dealing with audit quality:**

- Structural factors -
  - Profile of the profession should match the profile of the industry that it seeks to audit.
  - Profile and size of the audit firm is critical.
  - Choice often leads to concentration of work with a few firms. Efforts should be made to strengthen and expand smaller firms.
  - Manner of appointment of an auditor.
  - Auditor’s compensation, and its appropriateness.
  - Auditor’s independence.
  - Firms with multi-disciplinary expertise should deal with multi-disciplinary organisations.
- Environmental factors –
  - There is a need to address the whole financial ecosystem, instead of focussing only on auditors.
  - Audit is the sixth line of defence - Operating persons, who are the owners of certain controls and processes; Compliance Officer; Operating management; Internal Audit; Board and AC being the first five. Each of these lines of defence must perform.
  - The findings of proxy advisory firms and credit rating agencies also influence audit.
  - Regulators also have a role to play in ensuring the quality of audit, and providing oversight.

- Execution issues –
  - Auditor should understand his role and responsibility, including in the case of consolidation, wherein he relies on the audit report of another auditor.
  - Audit procedure should be built with care, factoring in sampling, methodology, inputs etc.
  - Tools and technology that are used.
  - Evaluation of audit test results, including *inter alia* whether the auditor miss any “smell”.
- Output factors
  - Quality of communication of the auditor with the AC – what should he tell, especially with a number of ACs not listening to auditors; ACs too should ask the right questions.
  - Auditor’s report – Should it be binary or speaking? It should be more communicative.
  - Management letter, which gives more detailed observations for managements to act upon, and which has now disappeared, should be a part of the auditor’s report.
  - Group audit.
- Oversight and evaluation –
  - Quality of oversight on audit is important, and the AC should play a big role in this.
  - Evaluation requires a structured mechanism, backed with data, and a common methodology to be followed across companies.
  - Inspection of audit engagement by Regulators.
  - Peer review.
- Other factors
  - Frequency of audit – it is believed that more frequent audits will have a positive effect on audit quality.
  - Timelines for publishing audited results – a balance is required to be maintained, and there should not be a rush on the part of the companies to publish their results.
  - Transparency – There should be full transparency while dealing with failures, and this should be backed with root cause analysis.

### **Collective responsibility**

- Audit is the collective responsibility of the management, the auditors, the Internal Audit, and the AC. All lines of defence are equally important.
- Accountability of the process at each line of defence needs to be improved.

### **Role of Management**

- The primary responsibility to ensure the robustness of audit is with management, and not the AC, which has only non-executive Directors, and which meets once in a few months.
- Management provides the inputs for audit. The quality of input decides the quality of output.
- It is important for managements to ensure the correctness and the completeness of the inputs provided.

### **Role of Audit Committee**

- In the event of a financial failure, the blame is laid on the AC, especially the Chair of the AC.
- The auditor has to be challenged by the AC for him to perform his role effectively. In many instances, auditors are not challenged enough by the AC. In other instances, they do not have much support from the AC. Different ACs react differently to auditors -
  - Some ACs work with auditors to find solutions.
  - Some ACs do not want any issues to be highlighted.
  - Some ACs are indifferent, even if issues are flagged to them, and do not want to act on the issues.

- While blaming the AC alone for the failure is incorrect, the AC has some important roles to play, to help improve the audit quality, and reduce the likelihood of financial failures.
  - It must take responsibility for selecting the right auditor, and ensure that he does his job well.
  - It must ensure that the auditor is given the space to perform his role independently.
  - It should ask the right set of questions to the auditors.
  - It has to strengthen the statutory audit and Internal Audit functions.
- For this, the composition of AC should be strong. However, the quality of composition varies greatly across companies.
- If the AC is strong, the AC members would be able to assert themselves when they know that they are right/ the management is wrong.

### Role of Auditors

There is a lot of work to be done by auditors too.

- There is no standard quality of audit delivered by different auditors. Also, the consciousness to improve the quality is lacking in many auditors.
- Standards of auditing have to be raised by setting an example. Bigger audit firms can take a leadership role in this.
- Auditors should stop treating managements as their clients.
  - In United Kingdom, the level of involvement of the AC in the appointment of auditors, their remuneration, and assessment, gives the impression that auditor does not have to please the management alone.
  - There is a need to bring a cultural change, and recognise that management is not the only client. There are other stakeholders involved in the audit process.
- Auditors should focus on improving audit quality, as their topmost priority. This is a focus area in some good audit firms, where performance targets are set, and objectives laid down, for everyone in the firm.
- Auditors should invest more in learning and development, and skill building of their team members, and in better quality resources.
- High non-audit fee, as compared to audit fee, results in an adverse impact on the independence of the auditor. Steps should be taken to reduce this to the bare minimum.
- Audit of processes, and not of transactions alone, should be done. This cannot be done if auditors are appointed towards the end of the FY.
- Also, the output for audit is provided by junior persons from the audit team, and the Signing Partner usually becomes a part of the process towards the end. This is also a possible area of concern since the Partner would be in a better position to gauge the culture and the DNA of the company, which will help improve the audit quality.
- Too much reliance is placed on management representation at present. This is not always good.
- Audit findings should be transparently presented to the AC.
- Data analytics and technology can play a huge role in improving audit processes, and firms must invest in these.
- Audit is no longer only about knowing accountancy. Cross functional expertise, including sectoral expertise, is important. This would help in obtaining a holistic view.
- There are situations wherein while the paperwork is perfect, the auditor knows that all is not right. But he cannot point out to any problems since he does not have any proof. Calling out such companies will go a long way in improving the audit quality. A single auditor will not be able to play this role, and this will have to be done by auditors as a collective.

- There are also situations where the auditor's opinion is influenced by the Promoter. It may not be a case of failure of judgement on his part. This problem cannot be wished away in companies where there is an overwhelming promoter presence. With the support of other auditors and the AC, this can be reduced, if not eliminated.
- Joint audit is not necessarily a solution. With multiple auditors, there is the possibility of unproductive competition. However, some auditors feel that this may be a step in the right direction, with two firms, as against one, owning the Audit report, and there being a distribution of the risks involved.
- Change is required, but change management is a skill. Audit firms, which otherwise maybe competitors, should come together, and define some basic standards and matrix, industry-wise, to improve the audit quality. Thinking professionals will have to come together to create processes, so that any one person is not unfairly pinned down.

### **Role of Regulators**

- Regulators in India should modify their approach when dealing with auditors. There is a need for building trust and for constructive dialogue. At present, there is a trust deficit. Also, dialogue, if any, is initiated in a haphazard manner.
- Internationally, there is a constructive balance between fear and respect. Auditors respect the Regulators, but know that if they do not do a job properly, they will end up on the wrong side of the Regulator.
- There should be a continuing conversation between auditors, and those that regulate the profession, not restricted to only the ICAI. Some of the problems could be owing to lack of understanding between the two.
- Increase in disclosures alone is not helpful. The quality of disclosures is equally important. For instance, the reporting on Internal Financial Controls in India is similar to the reporting on this internationally. However, the quality of such disclosures is far superior internationally.
- Regulators should give some thought to having some meaningful processes, that can be followed by all auditors, with short term, medium term and long term objectives.
- RBI has modified the Long Form Audit Report, which mentions the deficiencies which get highlighted in the audit process, in great detail. However, it is unclear as to who takes these findings to their logical end. This problem is accentuated by the lack of skilled accounting professionals, working with the Regulator.

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