

## AUDITORS' DILEMMA – TO SIGN OR TO RESIGN?

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MUMBAI

### SUMMARY OF DISCUSSIONS

#### CONTEXT SETTING

*The spate of resignations of auditors, in recent times, has been a very disquieting development for all stakeholders. Central to stakeholder satisfaction is the sign-off by the auditors on whom considerable faith and trust is placed. Are these resignations an indication of deteriorating governance standards? Have the recent regulatory changes forced auditors to review their risk-reward trade off?*

#### DISCUSSIONS

- At least 50 auditors have resigned from their audit assignments in the near past. While some believe that this is an initial rush, with not too many new resignations in the pipeline, others feel that this is an early warning signal which should not be ignored.
- Most of the resignation letters on Google cite preoccupation as the reason for resignation. Even Google has a few samples of such resignation letters.
- Resignation of auditors is being seen by a few as the auditors' way of showing that they are doing the right things as also their willingness to come under greater scrutiny and public glare. However, some others feel that it could be a sign of low tolerance on the part of the auditors.
- Stakeholders depend on the auditors' report for comfort. IDs too rely on the auditors' report, especially on account of an increase in their liabilities. With their quitting, this comfort seems to vanish. However, to place the blame on only one person, the auditor, an ID, or the Chairperson, would be wrong.
- If an auditor has a problem, she should stay and fight, rather than resign.
- As of now, no regulator has ordered any enquiry.

#### Changes in Political-Social-Legal environment

- In recent times, there have been a number of political and social changes.
- There have also been a number of changes in law and regulations, with laws becoming stricter and additional penalties being imposed on auditors, if found guilty.
- The scope of work for auditors has also increased under the Companies Act, 2013 with auditors also having to be responsible for accounts of subsidiaries that they had not audited. This was not the case earlier.
- With the setting up of National Financial Reporting Authority (NFRA), a number of powers would be exercised by this body, and the Institute of Chartered Accountants of India (ICAI) would cease to be the only disciplinary authority for the profession.

#### Stricter scrutiny of audit firms

- Securities and Exchange Board of India's (SEBI) order, in respect of Price WaterHouse (PW), in the case of Satyam Computer Services Limited, is sometimes cited as one of the reasons for resignation of auditors.
- United Kingdom's Financial Reporting Council's (FRC) criticism of quality of audit by KPMG too has intensified the scrutiny of audits done by the Big Four. This too could have resulted in some partners being careful in their audits in other jurisdictions, such as India.
- There is an increased public scrutiny of audits and an increased role played by media. At times, media exaggerates the situation, which could *inter alia* adversely impact reputation.

#### Management, Audit Committee (AC) and Board

- If inadequate information is given to auditors by management, the auditors should approach the AC.

- If, on the other hand, an auditor is not comfortable with the information provided to her or with the financials given to her, she should not sign the report.
- A truly independent AC should ideally be a part of the solution in holding the management accountable in case required information is not provided to the auditors.
- Resignation should only be the last resort. Ideally, auditors should push back for information.
- The problem is increased when non-AC members rely on AC members and do not discuss/ read the financials.

### Auditor appointment

- Auditor appointment is reflective of the quality of governance processes in the company. If right from the Board to the AC to the auditor, every person does her role properly, the situation will not degenerate into the auditor resigning.

### Diligence by auditor

- Auditors should do a due diligence of the potential client before taking a new assignment.
- Further, if an auditor does a little diligence/ uses her judgement, she will ordinarily be in a position to find if the numbers given by the management or the promoter are wrong. This would go a long way in the long run for all the stakeholders.

### Promoters

- With a number of promoters now hiring professional CEOs, it is very important for promoters, who are also shareholders, to listen to auditors.
- However, in some cases, there could be auditors who hold the promoter to ransom with threats of quitting if the latter does not agree to the seemingly unreasonable positions taken by the former.

### Investors

- The appointment of auditors is by and on behalf of the shareholders, and it is they who appoint them. This fact is completely lost on a number of auditors.
- For an investor, having blind faith in, or placing complete reliance on, the auditors' report is wrong. An investor should check the quality of disclosures and the extent of disclaimers, and conduct her own tests before judging a company.
- An investor would prefer that an auditor qualifies the accounts, rather than quits her assignment. She should mention where the gaps are.
- There can be a *de-facto* and a *de-jure* view to the role of auditors in certifying the financials of a company. The *de-jure* view is that the auditors are held to high standards and that they should conform to it. The *de-facto* view is that auditors are in a self-preservation mode since a number of changes have resulted in increased expectations from them.
- According to the Stewardship theory, there should be certain mechanisms in place from the point of view of an investor. Since those are not in place, management should have some internal processes.

### Qualifications by auditors

- Sometimes qualifications by auditors could signify that there has been lack of information on some aspects. Ideally, in such an event, the AC should step in and facilitate this information.
- There are situations when there could be resistance from the management and/or promoter to put qualifications in the report. In such situations, if an auditor resigns, it brings to the notice of all the stakeholders that something could be wrong with the financials of the company. However, management may defame and fire the auditors before they choose to resign.
- If there are qualifications in the auditors' report, corporate governance standards of the company in general should be checked.

- Even though a number of persons believe that financials are presented in a format which is not easy to read, if the qualifications are read properly, stakeholders will be in a position to understand the true situation of the financials of the company.
- A number of qualifications can be addressed if the right person(s) from the top management and/or AC member(s) ask the right questions. However, this is rarely done. Further, if a qualification is given, the Chairperson of AC is to sign the report. Even then, in some companies, AC Chairperson does not ask any questions.
- Earlier, SEBI had seemed to suggest that it might not accept reports with qualifications. However, the present situation is that the company has to provide an explanation in case of a qualification. Further, SEBI wants all qualifications to be quantified and in case an auditor cannot do so, the responsibility of doing so is with the management.
- An audit report is a black or white document. The regulator or the Ministry of Corporate Affairs (MCA) and management should not discuss the qualifications, as was earlier proposed. Further, the regulator might not have the bandwidth to do so given the large number of listed entities. If at all, these discussions should be done between the investor and the management.

### **Why resign prior to signing for Q4**

- Auditors had reviewed (limited or otherwise) the financials of the company for first 3 quarters, and so a number of persons feel that their resigning before signing the financials for the full year is wrong.
- However, some others feel that a number of items are kept for the fourth quarter and so even if an auditor has performed a limited review for the first three quarters, it is possible that with some new issue being raised in the last quarter, she could legitimately want to leave.

### **Herd mentality**

- If a big audit firm resigns, another firm is usually happy to take the audit and certify that the financials are okay. This arises from the fact that there is an excess supply of audit firms who are willing to take new statutory audit assignments, especially in the post-rotation situation.

### **Lack of role clarity for auditors**

- Some auditors are not sure of their exact role. Whether it is limited to auditing or do they have to help clean up or act as a consultant/ advisor is not clear to them.
- Further, a number of auditors do not get support from the management, the board and the shareholders, thereby making their task difficult.

### **Changes in audit report from next year**

- From next year, auditors' report will be more detailed, with key audit matters being reported. If an auditor is not comfortable with the detailed disclosure, she might consider resigning this year itself.
- Stating of key audit matters will be based on the presentation of the auditors to the Board. Inaccurate reporting by the auditors would then be a problem, despite the possible increase in disclaimers in the auditors' report.

### **Detailed reason for resignation**

- Auditors wishing to resign should explain and exit. Merely citing pre-occupation or lack of information as the cause for resignation is not sufficient. Language should not be used to conceal the real intention.
- Presence of the exiting auditor in the following Annual General Meeting (AGM) to explain the reason(s) for resignation to shareholders should be made mandatory.
- Resignation of auditors should be accepted by the shareholders since they appointed the auditors.
- ICAI too can give directions in the matter and state that detailed reason(s) for resignation should be given.

- Giving detailed reason(s) for resignation also becomes important because in extreme cases, with both the company and the auditor stating that they terminated the appointment/ quit respectively, the reality should be in public domain.

### **Fees of statutory auditors**

- Incentive for auditors to continue as statutory auditors is reducing consistently.
- Auditors have an option of engaging in assignments of statutory audit, internal audit, advisory and/or consultancy. The income from statutory audit is the least and the liabilities from the assignment are the maximum. If there is a mechanism by which the incentive for undertaking a statutory audit is increased, it may force auditors to consider the financial aspect too before resigning.

### **Flexibility in auditing standards**

- National Advisory Committee on Accounting Standards (NACAS) gives a principles based approach to accounting standards. As a result, there is discretion in the way management prepares/ presents the financials. IndAS too gives flexibility to management in the manner in which financials are prepared. The auditor is only to certify that the financials represent a true and fair view.

### **Guidelines of ICAI**

- There are 3 options available to auditors if they do not want to give a clean report –
  - Disclaimer of opinion – it implies that an auditor is unable to express an opinion on a matter.
  - Qualified report – it implies that except for the matter under qualification, the financials reflect a true and fair view.
  - Matter of Emphasis – it implies that in the auditors’ judgement, the particular information is important for the users of the financial statements.
- The informal guidelines of ICAI states that an auditor should ask for information from management only till a point, post which, she may consider whether to continue with the assignment or not. However, ICAI does not directly state that an auditor should quit.
- So in some situations, if the management does not provide information, and the Board is unresponsive, resignation may be inevitable.

### **Role of Internal Audit**

- Internal audit is supposed to find divergence, if any. With statutory auditors resigning, the work of internal auditors too should come under scanner, which is not the case at present.

### **No option of quitting with auditors**

- Since the appointment for an auditor is for 5 years, ideally, there should be no option for the auditor to quit, unless she is incapacitated.
- There should be a downside for auditors who choose to resign, and this should be substantial. This should be based on the potential loss to persons who rely on the information provided by the auditors.

### **Role of Key Managerial Personnel (KMPs)**

- Role of KMPs in the event of an auditor resigning too should be checked since it is their role to provide the necessary information to auditors.
- In case KMPs do not want to give excessive information to the auditors, they may desist from doing so because management/ promoter can easily change them in case they are found to be siding with the auditors.

### **Possibility of joint audit**

- Joint audits should not be resorted to only as a solution to the existing problem.

### **Common pool for payment to auditors**

- To ensure that statutory auditors are independent of management, payment could be made to auditors from a common pool, which could be created with contribution from each company.

### **Independent rating for auditors**

- An independent rating for all auditors could be done by an independent body. This could help in the objective appointment of auditors.
- Benchmarking of the work of auditors too could help.

### **Banking sector**

- In the banking sector, the process of appointment of auditors is much more stringent.
- Further, the entity is subjected to an additional audit by Reserve Bank of India (RBI) which throws up divergences, if any. However, divergence may not be only on quality of financials. These could also be caused based of different interpretations of RBI circulars by different banks.
- Further, with every bank being told that there are huge divergences, the confidence in auditors may be destroyed.
- At present, with banks coming under pressure, quality of audit and financials is coming under scanner.
- A number of auditors feel that a number of issues can be solved if auditors of Public Sector Banks (PSBs) and the inspectors of RBI try and sort issues arising from audit.

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Given that our founder, Mr. M. Damodaran, introduced Clause 49 of the Listing Agreement, dealing with corporate governance in India, and has been a part of both public sector and private sector Boards, as well as performing and underperforming Boards, we offer experience based consultancy and courses on the journey from compliance through governance to performance. Further, given his success in turning around organisations that had been written off, we are uniquely positioned to offer courses on leadership, organisational transformation, and building winning teams.

EEPL has a number of highly experienced and renowned consultants and faculty members who have helped, and continue to help, us deliver programmes that have been well received.

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