BEYOND THE NUMBERS
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SUMMARY OF DISCUSSIONS WITH AUDITORS

RATIONALE

The Companies Act, 2013 makes the auditors responsible for an increased number of functions. The resultant challenges that it poses to auditors seem to have been inadequately addressed. Auditors being, atleast in the perception of investors and regulators, the repository of their faith, have to be seen as measuring up to the expectation that they help to keep the company on the straight and narrow path. It is obvious that with complex responsibilities, limited availability of time and the increasing complexity of financial instruments, auditing is not a task for the faint-hearted. How do auditors address the host of issues that derive from their position and resultant responsibility?

DISCUSSIONS

STRUCTURAL PROBLEMS

- There are inherent structural problems in the system and in the relationship between the Board, the management and the auditors.
- The ultimate client of an auditor is the shareholder, since shareholders appoint the auditor. However, in reality, the appointment as well as the fees of the auditor is decided by the management, with the shareholders nodding in agreement.
- An auditor gives her judgement/ opinion based on the financials of the company that are given to her by the management. If she is too critical in her opinion, there is a pushback from the management at the time of her reappointment. This inherent structural duality has never been addressed. This could be a cause for threat to the independence of smaller audit firms.

SELECTION PROCESS OF AUDITOR

- One of the biggest considerations while finalizing an auditor is the auditor fees. Experience of the auditor and expected time commitment are rarely considered. Institute of Chartered Accountants of India (ICAI) has recommended fees slab based on the expected involvement of auditors, but the recommendation is rarely followed by companies.
- Ideally, there should be a computer software that should decide the auditor after matching the needs of a company with the size and competence of the audit firm.

THE COMPANIES ACT, 2013

- Overprescription in the Act has resulted in an increase in challenges to and expectations from the auditors. The Act is premised on lack of trust. Business is assumed to be a liability and not an asset.
- With an increase in penalties and more prosecution clauses, some audit firms are facing the peril of extinction. Attracting newer talent is proving to be difficult.
- Self certification, in place of certification, should be encouraged.
- Materiality threshold, especially for fraud reporting, should be defined.
- Earlier, voting was not taken seriously on appointment of auditors. However, now, Foreign Institutional Investors (FIIs) are sometimes voting against auditor re-appointments too. It will help audit firms in case there can be a provision whereby they cannot be removed for a longer period, say, 5 or 10 years.

AUDIT COMMITTEE (AC)

- Companies should focus on the constitution of AC since the effectiveness of the Committee depends on its composition.
- A few Directors do not understand the issues raised by auditors.
- Meeting of auditors only with the Independent Directors (IDs)

- In companies where auditors and IDs meet without the presence of management, enough time is budgeted for such meetings.
- However, the effectiveness of such meetings ultimately depends on both the IDs and the auditors. If used effectively, such meetings are useful.
- Typical questions that IDs ask auditors are:
  - *"Do you have anything to tell us?"*
  - *"Was the management cooperative with you?"*

AUDITORS AND MANAGEMENT

- Sometimes, managements have a tendency to hold back information from auditors.
- Financial departments in most companies are not equipped to handle challenges, especially the recent changes on the accounting front.

INTERNAL AUDIT

- While an increased number of companies have internal audit, internal audit function and internal auditors are not independent of the management. In most companies, this function is understaffed, and so it relies on management for help. In turn, the management decides the matters to be looked into by internal audit and as well as presented before the Board the manner in which it will be presented.
- Ideally, companies should have an internal audit administrator and the work of internal audit should be outsourced.

RELATED PARTY TRANSACTIONS (RPTs)

- Companies will have RPTs.
- As per the Companies Act, 2013, only majority of minority shareholders can vote on RPTs. This is unfair to the promoters, the majority shareholders.

GUIDANCE BY COMPANIES

- Guidance and forward looking statements are basically the same. Both of them put pressure on the company.
- While the opinion is divided on whether companies should send out guidance or not, companies send them because analysts and proxy advisory firms are considered to be important stakeholders.

ANNUAL GENERAL MEETINGS (AGMS)

- Auditors should have a bigger role in AGMs. Instead of the present practice of the Company Secretary reading the auditor's report, the auditor should read the report, or the important points from the report.
  - An alternative to the auditor reading the audit report could be a video of the auditor reading the report being uploaded on the company's website.
- This will also help increase the comfort of shareholders.

FRAUDS

- Fraud should be treated as a one-off.
- In the Companies Act, 2013, the definition of fraud is vague and subjective, and as a result management and auditors are at crossroads while defining a fraud.
- It is in the interest of management to ensure that there is no fraud in the company.
- As per the Companies Act, 2013, auditors have to report in case they suspect a fraud in a company to
  - Audit Committee
    - AC is likely to ask the auditors whether they have reported the fraud to the police, and filed a FIR etc.
    - This is for the auditor to do and she would not like to get involved in this.
  - Government

        - Reporting to the government is important because management might try to influence the auditors. An enquiry by the management would not help either because that may take very long.
    - Registrar of Companies (ROC)
        - However, the action that ROC is likely to take is not specified.
- Materiality threshold for fraud is available, but it is a broad based framework, and so is judgemental. There is no mathematical formula that can be used. For fraud reporting., materiality threshold should be used because:
    - ROC's absorption capacity is limited.
    - If the cost, time and bandwidth are considered, it does not make procedural sense to treat major and minor frauds similarly.
    - Fraud could be a result of a process issue.
    - Government and ROC might not want to get involved in petty frauds.
    - As per the auditing standards, materiality should be overriding.
- However, it is important that no fraud, irrespective of its size or quantum, goes unreported. A small fraud, if unchecked, could result in a bigger fraud later. Also, this can adversely affect the culture of an organization.
- While fraud reporting is in the interest of shareholders, they get adversely hit because as soon as a fraud is reported, the price of shares is impacted adversely.

ROTATION OF FIRMS

- Rotation of audit firms is good because:
    - A fresh set of eyes is useful to check what might have been overlooked. An old auditor might overlook towards some things.
    - It helps improve the perception of the company to outsiders.
- Joint audit is helpful and a preferred option because a new audit firm takes some time to understand the business of a company. However, companies do not opt for a joint audit by two audit firms since they consider it a wasteful expenditure.

INSPECTION BY THE GOVERNMENT/ REGULATOR/ ICAI

- Reserve Bank of India (RBI) inspects the books of financial institutions to check the financials, bad debt, amounts to be written off etc. to prevent frauds.
- Securities and Exchange Board of India (SEBI) too appoints auditors.
- Ministry of Corporate Affairs (MCA) too has decided to appoint auditors. However, the effectiveness of this process is yet to be ascertained.
- ICAI undertakes peer review of auditors on random basis. They have also started quality review.

INTERNATIONAL FINANCIAL REPORTING STANDARDS (IFRS)

- Bigger companies have mastered IFRS.

INTEGRATED REPORTING

- The world is moving towards integrated reporting and continuous audit to ensure that value is delivered on three counts:
    - Financial reporting
    - Environmental reporting
    - Social reporting.
- This also aids management and analysts in decision making.
- To promote integrated reporting, companies have to increase their speed of response and keep their accounts up to date. While companies are finding their own ways to do this, in India, the same economic transaction does not mean the same to every entity involved in the transaction.

PROBLEMS FACED BY AUDITORS

- While there in no timeline for submitting the financial statement to the auditors, companies want to be the first in their industry/ sector to declare the results. As a result, auditors get inadequate time for auditing. This gets further complicated if the company has business in multiple locations, with different auditors at these locations.
- Consolidation of parent company accounts and subsidiary accounts continues to be a huge challenge.
- There is a lack of role clarity for auditors.
- Inability of companies to look beyond the Big 4 accounting firms for audit because the companies are taken in by the marketing efforts brand value of the Big 4.
- Earlier familiarity of management or company with an audit firm was considered to be an asset. However, now it might have to be treated as a liability.
- Due to limited time between a Board meeting and the declaration of results post the Board Meeting, auditors do not get enough time to understand or make changes to their report based on the Board's recommendation.

WAY FORWARD

- Auditor must have a role and voice in deciding the audit plan for the company.
- Companies should appoint individual auditors and not an audit firm. This is important because virtues such as honesty, personal ethics etc. can belong to an individual and not a firm. This was also help in restricting accountability and ownership for the audit process to an individual, and not the firm.
- There should be guidelines prohibiting companies from publishing their accounts before a certain date, so as to leave the auditors with enough time to do a worthwhile job.

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Excellence Enablers Private Limited (EEPL) is an initiative that focuses on implementation of better corporate governance practices, improvement of Board performance, including audit and evaluation, training of directors and engagement with stakeholders of governance. It is founded on the firm belief that the gap between performance and potential can, and must, be bridged. Consistent with that belief, all our offerings are tailor-made to the specific needs of the organisation or the individuals concerned.

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.