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Speaker at Panel Discussion on “Process of Appointment of Independent Auditors”.

The question of how independent auditors should be appointed is an often discussed one. There is a strong view that the present system of appointment of auditors is not very effective. However, it is also a fact that no satisfactory alternative method has been found across the globe or has seriously been experimented with. We have today a system by which private sector entities, whether they are small or whether they are Public Interest Entities, appoint auditors by resolutions of shareholders. Public sector entities and government bodies and local bodies appoint auditors from a panel or by a tendering process or by direct intervention of the regulators. The controversy is on the appointment of auditors in the private corporate sector. The question that is asked is whether appointment by shareholders is a reality or in fact the appointment of auditors is appointment by management which later is approved by the shareholders.

Why is this process considered defective? The heart of the audit is exercise of professional scepticism and it is part of the auditors' job to challenge management assumptions. The question arises whether the auditor who is de facto appointed by the management is independent enough to challenge the management's presentation of financial statements. It

does not matter whether the auditor is a bloodhound or a watchdog. It is axiomatic that no dog ever bites the hand that feeds it.

There is another reason why the matter of auditor independence and method of appointment comes up again and again. The reason is that the world is witnessing recurring audit failures. The world has been shaken by large audit failures with predictable regularity. Enron did not teach the auditing profession any lesson. Enron was followed by many scandals such as WorldCom, Tyco, HealthSouth, Freddie Mac, AIG, Bernie Madoff, Wirecard, Carillion, General Electric etc. In India Satyam was followed by major audit failures in two large NBFCs. There have been also audit failures across corporate India as is evidenced by the experience of the recent beginning of insolvency proceedings. It is seen that in the insolvency proceedings assets which are carried in the books at certain values realize only a tiny fraction when companies are sent into resolution or into liquidation. Statistics shows that till January 2020, 823 companies were sent into the liquidation process and only 6.6% of the admitted claims were realized at the end of the process. Overall asset recovery rate upto September 2020 was only 20.9% out of total admitted claims of Rs.10.48 lakh crores. This experience shows that even when going concern, issues were flagged, alternative models of asset valuation were not used and assets were carried in the books at unrealistic figures. This is a major audit failure in India. This recurrence of audit failures again and again brings up the question of how auditors should be appointed.

There is also another issue which brings this question of auditor appointment to the forefront across the globe as well as in India. Large audits across the world are done by a handful of auditors. In the UK all FTSE 100 companies (the largest listed companies in the UK) except for one are audited by only four auditors. In the UK again 92.4% of the FTSE 350 companies (the next tier) are audited by these four auditors. In a survey carried out in 2020, of the Fortune 500

companies in the US, it was found that out of the 457 companies examined all were audited by these four auditors. In India, according to a study done for the year 2018-19, audits of listed companies aggregating to 75% of the total market capitalization in India were done by only four auditors. This concentration of work at the top really leaves very little real choice for selecting an auditor. This concentration of work at the top also has led to a situation where the other auditors have not been able to build up capacity nor have not been able to attract talent and are not in any position to challenge the supremacy of the bigger auditors. In the US and in the UK, the next tier of firms are called the Challengers but they are far too small to pose a real alternative.

These two issues of audit quality and concentration are the reasons why the issue of methodology of auditor appointment in the private sector is often discussed. One alternative which is sometimes proposed is the appointment of all auditor from a panel or appointment by the regulators. We have seen this in India in the audit of public sector banks. However, bank audits in the public sector have been characterised by major audit failures. The Asset Quality Review done by the Reserve Bank year after year from 2016 onwards has found large NPAs which were not identified by the auditors, in spite of a specific duty cast upon the auditors to quantify and report on NPAs. A similar situation also prevails in the audit of public sector undertakings in which the CAG finds faults in the audited financial statements after the statutory auditor has finished his job. So, therefore, going by the Indian experience, the appointment of auditors from a panel or by the regulators will not be effective in improving audit quality. Recently, the Ministry of Corporate Affairs had floated a consultative paper on alternative methods of auditor appointment, but the industry reaction to the same was

vehemently negative. The criticisms against the panel method or appointment by the regulator method are:

- ❖ The fees offered are such that it is not possible to do an effective audit.
- ❖ Very often the panels are drawn up in a manner which does not take into account the capabilities of the auditors.

The panel method therefore, across the globe, is restricted to the public sector and to the audit of government entities and local bodies. We have therefore, today a situation in which the method of appointment by shareholders is widely used but has led to recurring audit failures and the alternative method is also not effective.

What then is the way forward? In my view the way forward lies in taking four steps. Firstly, the audit committees which select the auditors in large Public Interest Entities must follow a process of selection which is transparent, which is recorded and which objectively evaluates the capabilities of the auditors who are being considered. The European Union has a very well laid down process for selection of auditors by the audit committee. This involves judgments on:

- Quality of service provided by the auditor
- Objective indicators regarding the reputation of the auditor
- Academic and professional experience as well as technical knowledge of the audit team
- Ease of communication and interaction with the audited entity during the selection process
- Independence, objectivity and professional skepticism
- Industry specific knowledge / experience
- Technological support tools
- Proposed fees.

In my view, since the audit committee is dominated by independent directors who are not part of the management and is in a position to exercise independent judgement, they should control the selection process effectively to ensure that the auditor is not really an appointee of the management. The criteria laid down above should be objectively applied and the audit firm should be selected after a strict evaluation. Secondly, after the process of selection of auditors by the audit committee is over if the shareholders do not carry such resolution with large majority or near unanimity or if there is a significant minority group opposing the appointment of such auditor, the regulator should step in and intervene in the selection of auditors in an objective manner. Thirdly, if on a review of the audit, quality issues are found, the regulator also should step in to change the auditor. My last suggestion is that whenever an auditor resigns or is sought to be removed before the end of the term, the issues leading to such change should be investigated by the regulator and problems if any should be brought to the forefront.

It may be noted that a major intervention was made by the Reserve Bank of India on 27th April 2021 in the system of appointment of auditors in Banks and NBFCs. While the method of appointment was not changed, the RBI has laid down norms regarding which firms can take up such audits, has reduced the term of appointment of such auditor from five years as laid down in the Companies Act, has put a ceiling on the number of such audits that one firm can do and such other measures. It may be noted that this is not a change in method of appointment but an intervention in the methodology of appointment. Such measured intervention by the regulator is probably here to stay and is in line with the measures suggested above.

In conclusion, I reiterate that the methodology of auditor appointment is important but the issue of poor audit quality cannot be fixed by only changing the method of appointment of auditors. There is a problem with the present mandate of the auditor that needs to be changed.

The role and reporting requirements of the auditor have to be redefined. There are major reforms going on in the UK on these lines. Unless that is done, whatever be the method of auditor appointment, such problems will persist. We look forward to a consensus across the globe that the auditing profession needs to be redefined.