Focus

First Reaction
Governance Spotlight
Regulatory Overview
Thematic Research
Event Based Research
✓ **General Commentary**

Subscribe to
IiAS Research

Write to us
solutions@iias.in

Can a broken songbird sing?

Never waste a good crisis. The audit industry needs to be fixed and recent developments provide the perfect trigger to rethink its future.

It is a scary time for the big four auditors in India. Their worry is not so much the business model of providing audit and a myriad of non-audit services; that, if regulators demand, they will reluctantly tweak. It is the audit quality and the numbers they are printing, that shareholders, lenders and regulators are now questioning.

Look around. The Securities and Exchange Board of India (SEBI) banned PwC in 2018 from auditing listed companies for two years for its involvement in Satyam Computers Services Limited. Last month, the Reserve Bank of India barred SR Batliboi & Company LLP, an affiliate of EY, from carrying out statutory audit assignments of commercial banks for one year. The Serious Fraud Investigation Office has charged Deloitte Haskins & Sells LLP and BSR and Associates LLP (part of the KPMG network), for their failure in not disclosing the true financial health of IL&FS Financial Services Limited and the Ministry of Corporate Affairs (MCA) looks at banning them from undertaking audits for a period of five years.

How have things come to such a pass? Clearly, it’s been a while in the making.

For one, the change in audit rules. From principles of prudence and conservatism, which enabled auditors to certify that the numbers are ‘true and fair,’ there is a shift to ‘fair value’ which despite its theoretical underpinnings, has led to Sharon Bowles, a former chair of European Parliament economic and monetary affairs committee, to describe it as the ‘un-anchoring of auditing from verifiable facts’. My own experience while handling an IPO of a technology company in the late 1990’s was the trepidation of its CFO when asked to prepare US GAAP accounts, giving way to high-fives, when he realized that management assumptions could be far more generous than what his local auditors allowed. Indian audit rules are far more aligned with global rules today, than any time before.

And rather than being ‘useful to users’ fair value accounting has at often times left investors and various other stakeholders, at the mercy of the auditors – who have just ticked the box, rather than exercise their judgement: in Charlie Mungers words 'violated the most elemental principles of common sense.' Auditors defend themselves saying that it is difficult to over-ride management when it comes to exercising judgement on business issues; recent events suggest they need to show spine and push-back, as PwC has recently done.

Some argue that audit failure to provide robust results is a consequence of their cosying up to firms they audit, in the hope of non-audit related business. Today the big four companies audit 60% of the NIFTY 500 firms, thankfully not as dominant as in the UK (97% of the FTSE350) or US (99% of the S&P500). Deloitte's global revenues in 2018 were US$43.2bn, followed by PwC (US$41.3 bn.), EY (US$34.8) and KPMG (US$29.9bn). Between themselves they employ 1,005,753 people. Just to put their revenues in context, Morgan Stanley's global revenues for 2018 were at US$37.9 bn and those of Goldman Sachs, US$36.6 bn. The UK's Competition and Market Authority (CMA), in its recent review of the audit industry, found that each of the Big Four generates at least three quarters of its revenue from non-audit services.

What then needs to be done? Should they be splintered into smaller 'all service' firms, should they be vertically split into audit only and non-audited firms or should there be a hefty fine for each transgression and they be allowed to continue, if the market believes they are now too important to do without? If the market believes moving forward without them is too disruptive, this is the practical and most acceptable - but short-term solution.

As the big four audit firms brace themselves for a shakedown, it is not clear who the winners will be. The domestic firms, for the most, have merged with the big four - their skills and importantly, their roster of clients, was far too attractive to the majors to leave untouched. Can the handful of remaining domestic firms benefit from this? It is not obvious if they now "have-it" to compete; partly this is because the companies are much larger, more global and more complex, which puts the smaller firms are a disadvantage vi-a-vis the big boys. And in part, because investors push firms to embrace the Big Four. The current crisis provides them with an opportunity, and it will be a shame if they do not take advantage that this environment provides. No one will argue that we don't need more choice. Indeed, the more daring amongst us will argue voting out the big four (- assuming the regulators don't ban them) and bring in the smaller firms arguing that the big four have not provided the assurance their brands promised. HDFC Bank recently appointed MSKA & Associates, a firm outside of the big four. Its own credibility will compensate for that of its auditors. This could be the starting point of rejuvenating the industry, with the better governed firms moving beyond the big four.

In India, a Committee of Experts in its report to the Ministry of Corporate Affairs focussed on the ownership structure, found it in compliance with Indian law, and believed that the National Financial Reporting Authority will solve the various intractable issues that face the industry today. In sharp contrast the CMA in its report has suggested breaking-up the big four to increase choice and introducing joint audits, which will enable smaller firms to upskill themselves – the two issues which we In India grapple with today. Agreed that just having more firms will not solve by itself solve the quality problem. So, to this let me add a third, tight oversight over audits and auditors. The recently set up National Financial Reporting Authority (NFRA) has its work cut out.

Fourth, a contentious suggestion for the various stakeholders to consider, but entirely dependent on data. Should audit fees go up? Unless audit fees move up such that the auditor feels rewarded for the time, quality and even the risk of auditing, we will continue to see the big four chasing non-audit revenues and the smaller firms focusing on tax and loan syndication. This assumes that the audit firms are honest in reporting the audit fees they earn, and do not show a lower number by filtering-out certain heads. Increased fees can be double-edged as it may make firms more malleable. The converse is audit will not be a focus and cannot be desirable.

Change will take time and most suggestion need wider debate. Meanwhile I advocate institutional investors and even audit committees, get involved in the policy debates around audit standards. Albeit an arcane subject, the ramifications are too far reaching and too long term, to ignore. Quicker still, investors should be more questioning of audit reports and auditors should open-up to talking to shareholder who vote their appointment, rather than cite client confidentiality.

The chartered accountants, possibly envious of doctors driving with a sticker of either a red-plus sign or the Rod of Asclepius on their windshield, decided to march in step with them, and put a 'CA' sticker on their windshield. As an aside, my colleague Hetal Dalal often asks, what is the relative probability of someone stopping a doctor on the roadside for a medical emergency versus flagging down a bean counter to give a tax opinion. Coming back, having embraced and made their own a car-sticker, auditors should now go the full distance, by paraphrasing and embracing a line about physicians from the bible. Let me help with it. Auditor, heal thyself.

A modified version of this article by Amit Tandon, appeared in Business Standard on 21 June 2019 under the headline 'Can a broken songbird sing?'

Disclaimer

This document has been prepared by Institutional Investor Advisory Services India Limited (IiAS). The information contained herein is solely from publicly available data, but we do not represent that it is accurate or complete and it should not be relied on as such. IiAS shall not be in any way responsible for any loss or damage that may arise to any person from any inadvertent error in the information contained in this report. This document is provided for assistance only and is not intended to be and must not be taken as the basis for any voting or investment decision. The user assumes the entire risk of any use made of this information. Each recipient of this document should make such investigation as it deems necessary to arrive at an independent evaluation of the individual resolutions referred to in this document (including the merits and risks involved). The discussions or views expressed may not be suitable for all investors. The information given in this document is as of the date of this report and there can be no assurance that future results or events will be consistent with this information. This information is subject to change without any prior notice. IiAS reserves the right to make modifications and alterations to this statement as may be required from time to time. However, IiAS is under no obligation to update or keep the information current. Nevertheless, IiAS is committed to providing independent and transparent recommendation to its client and would be happy to provide any information in response to specific client queries. Neither IiAS nor any of its affiliates, group companies, directors, employees, agents or representatives shall be liable for any damages whether direct, indirect, special or consequential including lost revenue or lost profits that may arise from or in connection with the use of the information. The disclosures of interest statements incorporated in this document are provided solely to enhance the transparency and should not be treated as endorsement of the views expressed in the report.

Confidentiality

IiAS Voting Guidelines

IiAS' voting recommendations are based on a set of guiding principles, which incorporate the basic tenets of the legal framework along with the best practices followed by some of the better governed companies. These policies clearly list out the rationale and evaluation parameters which are taken into consideration while finalizing the recommendations. The detailed IiAS Voting Guidelines are available at our website. The draft report prepared by the analyst is referred to an internal Review and Oversight Committee (ROC), which is responsible for ensuring consistency in voting recommendations, alignment of recommendations to the IiAS' voting criteria and setting and maintaining quality standards of IiAS' proxy reports. Details regarding the functioning and composition of the ROC committee are available at https://www.iiasadvisory.com/about. In undertaking its activities, IiAS relies on information available in the public domain i.e. information that is available to public shareholders. However, in order to provide a more meaningful analysis, IiAS, generally seeks clarifications from the subject company. IiAS reserves the right to share the information provided by the subject company in its reports. Further details on IiAS policy on communication with subject companies are available at https://www.iiasadvisory.com/about.

Analyst Certification

The research analyst(s) for this report certify/ies that no part of his/her/their compensation was, is or will be, directly or indirectly related to specific recommendations or views expressed in this report. IiAS' internal policies and control procedures governing the dealing and trading in securities by employees are available at https://www.iiasadvisory.com/about.

Conflict Management

IiAS and its research analysts may hold a nominal number of shares in the companies that IiAS covers (including the subject company), as on the date of this report. A list of IiAS' shareholding in companies is available at https://www.iiasadvisory.com/about.

However, IiAS, the research analyst(s) responsible for this report, and their associates or relatives, do not have actual/beneficial ownership of one per cent. or more securities of the subject company, at the end of the month immediately preceding the date of publication of this report. A list of shareholders of IiAS as of the date of this report is available at https://www.iiasadvisory.com/about. However, the preparation of this report is monitored by an internal Review and Oversight Committee (ROC) of IiAS and is not subject to the control of any company to which such report may relate and which may be a shareholder of IiAS.

Other Disclosures

IiAS is a SEBI registered research entity (proxy advisor registration number: INH000000024) dedicated to providing participants in the Indian market with independent opinions, research and data on corporate governance issues as well as voting recommendations on shareholder resolutions of about 750 listed Indian companies (https://www.iiasadvisory.com/iias-coverage-list). Our products and services include voting advisory reports, standardized services under the Indian Corporate Governance Scorecard, and databases (www.iiasadrian.com and www.iiascompayre.com). There are no significant or material orders passed against the company by any of the Regulators or Courts/Tribunals.

IiAS further confirms that, save as otherwise set out above or disclosed on IiAS' website (www.iias.in):

- IiAS, the research analyst(s) responsible for this report, and their associates or relatives, do not have any financial interest in the subject company.
- IiAS, the research analyst(s) responsible for this report, and their associates or relatives, do not have any other material conflict of interest at the time of publication of this report.
- None of IiAS, the research analyst(s) responsible for this report, and their associates or relatives, have received any compensation from the subject company or any third party in the past 12 months in connection with the provision of services of products (including investment banking or merchant banking or brokerage services or any other products and services), or managed or co-managed public offering of securities of the subject company.
- The research analyst(s) responsible for this report has not served as an officer, director or employee of the subject company in the past twelve months.
- None of IiAS or the research analyst(s) responsible for this report have been engaged in market making activity for the subject company.

Disclosures relating to the subject companies

IiAS as a proxy advisor provides various services including publishing reports on corporate governance and related matters. The subject companies have subscribed to IiAS' services and IiAS has received remuneration from the subject companies in the past twelve months.

This page is intentionally blank

markets ∩ governance

About IiAS

Institutional Investor Advisory Services India Limited (IiAS) is an advisory firm, dedicated to providing participants in the Indian market with independent opinion, research and data on corporate governance issues as well as voting recommendations on shareholder resolutions for over 800 companies. IiAS provides bespoke research, valuation advisory services and assists institutions in their engagement with company managements and their boards.

In addition to voting advisory, IiAS offers two cloud based solutions - IiAS ADRIAN, and comPAYre. IiAS ADRIAN captures shareholder meetings and voting data and provides packaged data that can be used to gain insights on how investors view specific issues and gain greater predictability regarding how they might vote. comPAYre provides users access to remuneration data for executive directors across S&P BSE 500 companies over a five-year period.

Office

Institutional Investor Advisory Services
Ground Floor, DGP House,
88C Old Prabhadevi Road,
Mumbai - 400 025
India

Contact

solutions@iias.in
T: +91 22 6123 5509/ +91 22 6123 5555