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Auditors: Signing out

Although some investors view auditor resignations as a sign of auditors warding off pushy company managements, the immediate focus is always on understanding the reason for the resignation. Unfortunately, regulations do not provide for an open dialogue between the auditors, investors and other stakeholders.

Most investors characterize auditors as back-slappers of firms they audit, and not desk thumpers. So, the sudden rush of resignations by audit firms is bewildering to market players. Although some investors see auditors stepping down as a sign of assertive behavior, the immediate focus is on knowing how to deal with auditor resignations. The larger issue, and of far greater substance, is regarding the structure of the audit industry and its future.

An article in this paper reveals that on average, over the past five years, two auditors have resigned each month (https://www.business-standard.com/article/markets/auditor-resignations-not-all-that-rare-here-s-all-you-need-to-know-118060500048_1.html). Further, that while 38 auditors stepped down last financial year, 26 have already done so since April of this year. This relatively small number - given a total universe of 4000+ listed companies, cannot be a consolation: resigning an audit of a listed company should happen in the rarest of rare cases, and these numbers don't suggest this being the case.

Insisting that auditors cannot resign and asking for the audit to be completed with warts and all, is obviously the best option. But given that the auditor has resigned rather than sign qualified accounts, suggest that this stage has passed.

Are all instances *equally* worrying? There is a broad framework in which these should be viewed: those resigning after signing-off on the audit report, those quitting in their first year itself and finally those walking-out after a few years into their engagement, but before signing the accounts. The *least* worrisome, but an area of concern nonetheless, are accountants resigning the audit after the accounts are done and dusted. Usually the accounts are presented in a timely manner and the auditor's opinion on the accounts is generally offered. And since the auditors are present at the shareholder meeting, it is an added comfort, it gives shareholders a window to question them. The bigger red-flags are auditors deserting the company before the end of their tenure. This could be auditors resigning in the first year itself. The auditors, management and audit committee may not have planned well or been adequately engaged during the year,

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if the resignation has come in so late in the day. And one cannot rule out difference of opinion if the auditor hangs-up a few years into their tenure. The very least investors expect in such cases is that auditors provide a substantial reason for stepping down. Who the new auditor is also crucial.

Unfortunately, regulations today do not permit a more open dialogue between auditors and investors. The limited exchange is confined to the time of the annual general meeting, and it's regrettable that investors do not make the most of it. The National Financial Reporting Authority (NFRA), the body which in a manner is expected to 'replace[1]' the Institute of Chartered Accountants of India (ICAI), should add this to its list of tasks. But meanwhile regulators and if it's not too much to expect, ICAI too, should insist that at the time of resigning then auditors give *sufficient information to shareholders* to appreciate the reason for the resignation. SEBI has mandated this to happen from April 2019, but there is no reason it cannot happen immediately. And platitudes should be contested.

Turning to the structure of the industry itself.

For the last forty odd years, numerous global mergers and a scandal have resulted in the big eight (audit firms), shrinking in steps, to what are today referred to as the big four: PriceWaterHouseCoopers (PwC), KPMG, EY (Ernst & Young), and Deloitte & Touche (Deloitte). They are profitable oligarchies with aggregate revenues of US$134 bn (- the two largest Deloitte and PwC having revenues of around US$37 billion each, similar to those of Goldman Sachs). And they dominate the audit landscape auditing 99% of the S&P500 companies and 45% of all listed companies in the US (2017). In UK its 98% of the FTSE350 (2017) and 59% of all listed companies and 67% of EU (2016). In India this number is roughly 60% of the NIFTY500 - where data is available, and possibly 29% for all NSE listed firms. What should cause unease is that these firms have grabbed or maintained market-share despite numerous 'scandals' in the past many years? Grant Thornton, another largish firm has said it will no longer pitch for business from the FTSE350 companies, citing stickiness of the big four auditors.

How do you reduce their hold - and should you? If yes, any solution needs to factor in first, that the big four are a confederation of partnerships or network firms, so can there be a national solution alone? Two, given that audit, tax and technology are intertwined, how sensible is to separate the businesses? If not, how do you address the conflict issues? Three, can you attract the right talent to an audit-only firm? Four, how do you upgrade the skills of other (local) firms to compete effectively? Five, how to ensure

[1] A few will contest 'replace.' But given NFRA's role to monitor the functioning of auditors, with jurisdiction over all listed and large unlisted public companies, powers to investigate matters relating to misconduct by members or member firms, replace seems to be appropriate.

that more firms does not mean competing on lower audit standards and malleable interpretations. Add to this mix are the tangles that the ICAI has created, putting its (local) members interests above those of the stakeholders it serves: it has entrenched the vocation with its own terms of reference, its own guidelines, policing and penalizing its own. The parallel is with the BSE, which after more than a decade, is still fighting to take back share it lost to the NSE. Ashishkumar Chauhan, the CEO for BSE will vouch for how hard he is battling. The sooner the NFRA is set-up, the less will be the pain the ICAI members will face in reinventing themselves.

The expectations from the profession are higher than any-time before. Auditors vouch for the integrity of a company's numbers and are critical to the functioning of the market and the economy. SEBI through the Kotak Committee has reiterated this. They have even banned a big four firm for two years – virtually unheard in any other market. The MCA pushed through mandatory auditor rotation – and again not many other geographies have been firm enough to do. It's now for auditors to step-up and reaffirm the faith reposed in them.

A modified version of the above appeared in Business Standard on 19 June 2018. It is behind a paywall; subscribers to the newspaper can access it by clicking on this link or typing the following url: https://www.business-standard.com/article/opinion/auditors-signing-out-118061801280_1.html

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