**BOMBAY CHARTERED ACCOUNTANTS' SOCIETY**

# Representation to the Expert Group on issues relating to Audit Firms

# BOMBAY CHARTERED ACCOUNTANTS' SOCIETY

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## Bombay Chartered Accountants' Society

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## 1. <u>Current Scenario of Auditing Profession in India</u>

Auditing profession in India operates under two extremes:

- On one hand there are Multinational Audit Firms (MAFs) who are auditors to major multinational companies (MNCs) operating in India and large corporate groups of India. These MNCs would operate in India through their subsidiaries, joint ventures or have significant influence over the operations of the Indian companies.
- On the other side there are auditing firms mainly Indian Audit Firms (IAFs) having 2-5 partners who also undertake audits of large and mid-size corporates in the listed / unlisted and private companies. . These companies normally associate with such IAFs since the promoters have a long professional association with them.

<u>The Multinational Audit Firms (MAFs) who function in India typically have the following structure:</u>

- MAFs function through multiple firms which are affiliated to the MAF;
- The MAF entities who carry out the statutory audit function are normally structured as partnership firms and LLPs – there can be multiple such firms/LLPs with different partners, but having similar names /addresses. All these firms/LLPs also use the same brand name.
- **Each MAF has multiple entities for other activities – private limited companies for consulting, internal audits, tax advisory, M&A, etc.**
- These entities are normally structured to make sure that they do not get covered by ICAI restrictions of Code of Ethics regarding publicity, cross referrals, advertisement, independence, etc.
- These MAFs esp. the entities who carry out activities other than statutory audit, supposedly get specific grants from abroad and have separate budgets for advertising / brand building.
- It is believed that most of the MAFs have their parent entity registered in jurisdictions which are 'tax havens';

The above structure results in a major dis-advantage and absence of level playing field to IAFs esp. SME firms since the IAFs do not have the size and financial backing to be able to counter the MAFs.

## 2. Points for Representation before the Expert Group to look into issues related to Audit Firms

### 2.1 Whether there is an adverse impact on Indian audit firms from restrictive shareholder covenants?

- There are several Restrictive Covenants by Foreign Investors to appoint MAFs as auditors –. Many Private Equity (PE) Investors from India also follow this practice. In most cases, such covenants are present even in those cases where the investors do not have any majority stake. Due to such covenants, there is insistence of appointment of MAFs as auditors or replacement of IAFs as auditors.
- The reasons advocated for such clause is that the MAFs are much better equipped and can offer better quality. Such a claim would be clearly false – In fact, there is a study carried out by IIM, Ahmedabad which clearly proves otherwise. **Refer Annexure 1.**
- It is estimated that more than 25,000 Companies / JVs of MNCs have such restrictive covenants. Considering average fees for audit and other services at Rs. 10 lacs for such companies, the total revenue is 2,500 crores – the IAFs are clearly denied any part of these revenues.
- Restrictive Covenants for appointment of MAFs merely state the brand name of the MAFs rather than the name of the firms who would be doing the audit. For confidentiality reasons, the actual clauses contained in the PE agreements cannot be reproduced. The auditor appointment is, in many cases, made in the name of an affiliate of the MAFs, whose names do not appear on the MAFs websites. This itself gives credence to the fact that the MAFs though having a separate identity they are using the same infrastructure and personnel to execute the audit assignments in India and thereby using a surrogate practice of exploiting the clout of their brand and network and stifling the competition.
- In many cases, the MNCs are forming subsidiaries/JVs in India in security sensitive sectors like Defence, Shipping, Railways, etc. Restrictive covenants present in such companies could give undue advantage to the MAFs.

- <u>Besides, such practice can be clearly termed as Anti-Competitive since it artificially stifles competition and acts as a barrier for IAFs and lack of level playing field for IAFs.</u>
- Companies Act, 2013 empowers an Audit Committee as per Section 177(4)(i) to recommend appointment, remuneration and terms of appointment of auditors of the company. However, due to such restrictive covenants their role is restricted and compromised as the appointments are driven by Shareholder agreements rather than a discussion at an Audit Committee on the merits of appointing a particular firm
- On the subject of restrictive covenants, several publications and studies have been carried out – notable among them are studies by the House of the Lords in UK, OECD, European Group of International Accounting Networks and Associations (EGIAN), Association of Chartered Certified Accountants (ACCA), The Financial Reporting Council (FRC). All these studies consider the restrictive covenants as a major barrier to the development of the mid-tier firms and therefore, as an important cause of the current market concentration (*Source: ESCP Europe – Final Report – Study on the effects of the implementation of the acquis on statutory audits of annual and consolidated accounts including the consequences on the audit market , Paris, 9th November, 2011*)

## 2.2 **<u>Whether there is an adverse impact on Indian audit firms through the manner in which audit rotation is being implemented by companies?</u>**

- The Institute of Chartered Accountants of India (ICAI) had in the recent past permitted undercutting in audits.
- Mandatory Audit Rotation (MAR) in light of undercutting being permitted, is expected to have an adverse impact for IAFs. It is expected that over 70 percent of present clients of IAFs will move to the MAFs. This is because the MAFs with their deep pockets (esp. due to the subsidizing their audit practice with other services rendered by other entities) heavily resort to undercutting as an entry strategy.
- At a time when consolidation is necessary for the auditing profession, it is feared that the way MAR is being implemented, there will be reduction in the number of IAFs and they would be nearly wiped out or lose their stature. This will lead to the MAFs practically having a dominance on the audits in India. <u>This is clearly against the ***"Make in India"*** push strongly advocated by the government – this ***'Make-in-India'*** initiative should also be followed in the services sector as much as the manufacturing sector</u>.
- Appointing auditors is a key part of the governance of the company and it should be the company's Audit Committee, who have knowledge of the company, that makes the choice and is accountable for it. This also prevents any allegations of corruption, which could arise if a third party determined which firm gets the work. Detailed disclosure of the reason for the choice would also help to prevent the unwelcome spread of so-called 'restrictive covenants', mentioned earlier. The audit firms need to demonstrate their superior service, rather than simply being assumed by being part of particular brand.
- As per recent information, MAFs have audit revenues of Rs. 5,000 crores, while the top 20 IAFs (viz., firms with 12 or more large audits) have revenues of merely Rs 200 crores – this is less than 4 %. With the manner of appointments being considered on MAR, this gap would further widen, which is very detrimental to the auditing profession in India.
- In South Korea, a study by Kwon-Lim-Simnet (2010) – Mandatory Audit firm

Rotation and Audit Quality: Evidence from the Korean Audit Market, where MAR is adopted since 2006, measured the impact of mandatory firm rotation on audit concentration. Based on the 174 auditor changes due to mandatory audit firm rotation, they concluded that such a measure does not appear to be an effective mechanism to mitigate the dominance of the Big 4. Out of the Big 4 clients 77% chose another Big 4 and the remaining 23% a non-Big 4. On the other hand, out of the non-Big 4 clients, 44% switched to a Big 4 and 56% remained with a non- Big 4.

- A recent article by IFAC CEO titled "Mandatory Audit Firm Rotation—Are We Going 'Round in Circles?" also clearly brings out that MAR has not worked in most jurisdictions. **Refer Annexure 2.**
- Even if MAR is to be retained, it should be restricted to only the Top 100 listed entities (by market cap) and be removed for other listed companies and certainly for non-listed companies. Necessary amendments can be made to the Companies Act, 2013 for the same.

**2.3 <u>Whether joint audit could be introduced in cases where there are restrictive covenants and/or in other specified cases where there is a multi-national audit firm as the auditor?</u>**

- In India, PSUs/PSBs through CAG and RBI already follow the concept of Joint Auditors for most entities above a particular threshold. This has been very successful and has been thus time tested in India.
- <u>Joint Audits can also be similarly extended to all listed entities beyond a particular threshold based on net worth, turnover, etc.</u>
- The fear of additional cost of Joint Audits is unfounded as the overall cost may increase by only 5-10 % as compared to single auditors.
- Joint Audits will also enable the smaller IAFs to upgrade their skill set and serve the purpose of developing Indian professionals for 'Skill India' as targeted by the Government and give a fillip to the 'Make in India' initiative in the service sector.. This will also make IAFs future ready to also serve the International diaspora of auditing.
- French firms and regulators have praised the use of two audit firms as being a success in France – both on the basis that 'two pairs of eyes are better than one' and because the system allowed smaller firms to get exposure to listed company audits.

**2.4 <u>If joint audit is to be implemented, then the legal and regulatory steps towards the same.</u>**

- The concept of Joint Auditors may be explored to be extended to all entities above a certain threshold which can be based on net worth, turnover, etc. This will also offer a level playing field for IAFs and the MAFs.
- Regulatory framework for appointment of Joint Auditors is already in place through SA 299 – Responsibility of Joint Auditors.

### 2.5 <u>Practices in other large emerging market economies in relation to domestic audit firms/joint audit.</u>

- China has banned MAF and FDI in audit and only local Chinese firms can undertake auditing in China. The vision of China is to support and fund the top 50 local Chinese firms and make them into global audit firms.
- French firms and regulators praised the use of two firms as being a success in France – both on the basis that 'two pairs of eyes are better than one' and because the system allowed smaller firms to get exposure to listed company audits.
- In UK, the Big Four's dominance of the audit market was the direct focus of the Lord's inquiry and one of the key issues in the EC Green Paper. The 'systemic risk' posed by such an oligarchy and the fears of what would happen if four turned into three drove both inquiries to seek answers. ***(Source: ACCA Publication – Audit under fire: a review of the post-financial crisis inquiries, May, 2011)***
- The Financial Reporting Council (FRC) in June, 2010 had admitted that the concentration of Big Four had in fact increased post-financial crisis.

2.6 **India, as a global power in services, should aspire to have its own audit firms at international level. What measures can be taken to promote creation of international-level Indian audit firms which provide services outside India, particularly in developing countries, in competition with multi-national accounting firms?**

- There has to be upgradation of the processes and procedures for carrying out statutory audits especially by smaller IAFs. To achieve this, resources should be allocated for proper upgradation of skill set of the human resources involved in carrying out the attest functions.
- Since IAFs, are prevented from marketing their services citing the ICAI Code of Ethics, a level playing field should be provided whereby the MAFs are restricted from doing so or the ICAI Code amended to allow all firms to do so and explore professional opportunities. IAFs should also be allowed to be a part of international networks of accounting firms. thereby sharing of best practices around the world and provide internationally acceptable quality services.
- Joint Audits should be mandated for companies above a particular threshold based on turnover or networth;
- China has banned MAF and FDI in audit and only local Chinese firms can undertake auditing in China. The vision of China is to support and fund the top 50 local Chinese firms and make them into global audit firms. Likewise, India should also encourage promoting IAFs to play a major role in auditing in Indian Corporates, thereby gaining domain knowledge of various industries, their processes and apply the same to scale up at international level.

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