The Audit Revolution: MANDATORY FIRM ROTATION

*CA AASHEESH ARJUN SINGH

April 1, 2014 will be remembered as a very significant day for corporate India. On this date, 184 sections of the Companies Act, 2013 ('the Act') came into effect, and with it completely changed the Indian corporate landscape.

The landmark act included sweeping changes that are unlikely to be seen most lifetimes and will impact the way the way business is done in India through companies- promoter owned, multinational, large, medium and small.

Amongst the many changes, are a set of sections and rules that govern companies and their auditors, with the view to altering what many regulators believe are over- comfortable and long standing relationships between auditors and their audit clients. Relationships that threaten their objectivity to opine independently on the truth and fairness of those financial statements.

The law requireddefined companies to rotate their audit firm every 10 years. For the initial transition, corporates whose auditors that have already completed the defined period, have 3 years to make the change to a new auditor i.e. until the year ending 31 March 2017. It was good to note that the Act and its accompanying rules were very prescriptive to ensure that Indian companies and audit firms do not work around this requirement by setting up alternate structures and therefore defeat the substance behind this regulation.

In addition to listed companies, the Act covered unlisted public companies and private companies to change auditors provided they meet certain size thresholds on share capital, prescribed as 50 cr and 10 cr in private and unlisted public companies or borrowings in excess of 50cr. Effectively, making every listed company, private equity backed company and Indian subsidiary of global multinationals, a part of this mandatory rotation process. This triggered an unprecedented revolution in the Indian audit profession which thousands of audit firms.

As management and corporates boards make this change, what should they be looking out for in their new auditor? Is it institutional acceptance, the size or the potential global reach of the auditor, knowledge and skills or ability to understand the business? There is a research study in the US that indicates that the maximum restatements in company financial statements happen in the year following the change in an auditor. Therefore it is imperative for companies to break down their assessment of the new auditor into the quantitative and qualitative aspects, to give themselves adequate comfort on the appropriateness of their choice.

Firstly, technical competence of the auditor is important but in today's world can be taken as table stakes. Every auditor must know the technicals of their job, just as every CFO must know theirs. Same for institutional acceptance. Today a large number of auditors and firms are accepted by boards and institutional investors and that is not a differentiator as corporates make the decision. However, companies should make that individual assessment and it may be erroneous to believe that size equates technical depth.

Secondly, auditors need to have a very robust mechanism to monitor independence with their audit clients. The law has significantly expanded restrictions on the non- audit services that auditors can provide and any misstep would result in independence being impaired. Similarly the law has very extensive restrictions on audit firm partners or their relatives holding securities in their clients. Does the prospective auditor have a real time system to capture this information and ensure that breaches are identified/ cleared, no matter how potentially revenue generating these could be?

Thirdly, what is the prospective auditor's quality control system and what how does the auditor ensure compliance with the stringent quality standards demanded by the regulators? Was the audit firm or audit partner involved in any regulatory action in the past?

These quantitative measures will ensure that the auditor will get the job done and also be in compliance with the law. But these are the bare minimum that every auditor must have and what should be the differentiating factors in this selection? As the perception grows that audit services are potentially commoditised, it is the qualitative aspects that could drive decisions. Corporate demand value for money and what could be that value?

To start, an auditor's understanding of the industry and how it could

impact their audit process. As businesses have become more complex, global and innovative, so have the accounting and financial reporting frameworks. A service provider who understands a company's business is more likely to be able to interpret and relate that to the accounting framework. An auditor who understands the business is more likely to do a more focused audit and actually provide value to corporates in the process – potentially ensuring that misstatements are minimised but also adding value by making the audit more efficient and also highlight areas of improvement in the process.

Secondly, who would constitute the immediate team that would service the company? While an audit firm may have hundreds of employees, it is the immediate service team that management will interact with on a regular basis. Does that team have the understanding to manage a company of the size and unique nature of its operations? Do they have prior experience to understand corporate expectations and can they deliver to what they promise?

Thirdly, is the incoming auditor proactive or reactive? Do they work towards a solution or do they leave the company to find its way through the maze? Independence is sacrosanct but auditors should be able to discuss a solution within the overall independence framework.

Lastly, is the auditor able to service the needs of a corporate? Every one promises to reach for the stars but can they balance their various commitments and still exceed a corporate's expectations? Are they agile enough to give their views on a timely manner which may not necessarily be what the company would like to hear?

Companies and Audit Committees/Board of Directors would do well by thinking of a potential shortlist, the process for selection, and if appropriate, consider a switch at some subsidiaries in order to work with multiple firms and assess which firm best meets with their assessment before making the change at the group level.

So once a company has selected an auditor, how does it make the transition seamless and efficient? The answer to that lies in three simple words – planning, planning and more planning. It is here that the auditors and companies need to sit together and agree on a transition plan. Starting from the timely completion of appointment formalities to understanding the business environment of the company and the key accounting policies and interpretations applied by the Company, matters of discussions in the prior year and concluding those upfront and significantly prior to the end of the year under audit. It is also criticalthat significantly early in the year, both the company and the auditor discuss the audit process in the prior years and build on the areas that were well executed and also agree on how the process can be improved in the current year.

Another often overlooked aspect of this transition is timely meeting with the internal auditors and other stakeholders and understanding their areas of focus and views on the internal control systems and environment of the Company. Getting this perspective goes a long way in having a risk based audit approach and also focussing on key internal controls of the Company.

Finally, a critical debrief at the end of every audit to improve the process and also set the expectations and agenda for the next year.

An audit is a necessity but whether it ends up becoming a burden for the Company or a process for adding value, will depend on advance planning and on managing this transition in the midst of this Audit revolution. ■

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