

Report on regulating audit firms and the networks

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Overview

- 1 Recap
- 2 Rationale for regulating auditors
- 3 Oversight mechanism
- 4 Network structure
- 5 Brand name
- 6 Advertisement
- 7 Conflict of interest
- 8 Liability of auditors, firms and networks
- 9 Company not to practice as CA
- 10 Reciprocity
- 11 Multi-Disciplinary Practice (MDP)
- 12 FEMA

Section 1

Recap

Supreme Court judgement

- Supreme Court directed UoI to constitute CoE (para 53(i))
- CoE to look into:
 - ① Issues relating to enforcement of section 25 and 29 of Chartered Accountants Act, 1949 and Code of Ethics
 - ② Need for laws like Sarbanes Oxley Act, 2002 and Dodd-Frank Act, 2010 for oversight of auditors
 - ③ Need for exclusive oversight body for conflict of interest between auditors and consultants
 - ④ Examine steps for effective enforcement of FDI policy and FEMA regulations
 - ⑤ Any other remedial measures

Section 2

Rationale for regulating auditors

Market failures

- **Information asymmetry (agency problem)**
 - Shareholders v. managers
 - Controlling v. minority shareholders
 - Company v. creditors, employees, regulators etc
- Market power (competition)

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Section 3

Oversight mechanism

Whether India has appropriate oversight mechanism?

- US and UK have independent regulators
- US (pp. 24-28)
 - PCAOB regulates auditors of public companies
 - PCAOB under oversight of SEC
 - PCAOB can impose sanctions (monetary, debar)
- UK (pp. 28-31)
 - FRC regulates auditors of public companies
 - FRC delegated tasks to SROs for auditors of private companies
 - FRC can impose sanctions (monetary, debar)

Whether India has appropriate oversight mechanism?

- Position in India (pp. 40, 48-51)
 - CA 2013 brought in NFRA (s. 132)
 - Opposition by ICAI delayed implementation (p. 41, fn. 73)
 - Section 132 establishing NFRA has been notified in March 2018
 - NFRA is an independent regulator like PCAOB and FRC
 - NFRA to regulate auditors of listed and public companies
 - NFRA can
 - ① recommend accounting & auditing standards [s. 132(2)(a)]
 - ② monitor quality of audit [s. 132(2)(b)]
 - ③ investigate [s. 132(4)(a)]
 - ④ impose sanctions (monetary, debar) [s. 132(4)(c)]
 - ⑤ take action against individual CAs, firms [s. 132(4)(c)]

Recommendation u/4.1: India has adopted international best practice with NFRA (p. 46)

Strengthening NFRA

- PCAOB and FRC can:
 - conduct audit quality inspect for any firm
 - publish the audit quality report
- Example: PCAOB's PWC audit inspection reports

Recommendation u/4.1: NFRA should have similar power to inspect and publish audit quality report (p. 46)

Section 4

Network structure

Structure used by networks operating in India

- Pre-1988: Foreign brand names were allowed to be used by Indian audit firms
- 1988: *Chartered Accountants Regulations* came into effect
 - ① *Reg 190* - Register of offices and firms
 - ② Firm name needs to be approved by ICAI
 - ③ Names restricted to partners' name or *name already in use*
- Big 4 failed to get their names registered - networking route took off
 - KPMG case - Kapadia, Perrera, Makhijani & Girish refused KPMG (2002)
 - Deloitte, PwC - internationally names have changed - but continues with old names in India
- ICAI issued Networking Guidelines in 2005 - replaced in 2011
 - ① Domestic network - to be registered (Form B)
 - ② International network - to be declared (Form D)
- One major advantage of networking - branding

Types of networks operating currently in India

- Type 1 Network: Domestic network (p. 53)
- Type 2 Network: International network + membership route (pp. 54-55)
- Type 3 Network: International network + sub-licensing route (pp. 55-56)

Control of networks

- International networks present in India only through Indian firms
 - ① with Indian partners (p. 56)
 - ② partners members of ICAI (p. 56)
 - ③ Indian firm registered with ICAI (p. 62)
- Indian member firms follow common process, methodology of network
- *Control and supervision* is of such processes; not same as *ownership and control* for the purposes of corporate law (pp. 56-57)
- MCA Expert Group (Mr. Ashok Chawla) came to same conclusion

Findings u/4.3: MAF is a misnomer

Section 5

Brand name

Brand name

- Audit firm with a reputed international brand name enjoy a premium globally as well as in India
- Signals a superior quality of reported information
- Companies may benefit from using branded auditors
- Branding would help improve local Indian audit firms:
 - Advanced methodology
 - Better infrastructure
 - Attract better talent
 - Help Indian firms to expand size and business
- Branding is allowed in U.S., UK, China, Indonesia
- **Reco 4.4: Branding should be allowed. Regulation 190 needs to be suitably amended.**
(pp. 57-58)

Section 6

Advertisement

Advertisement

- Restrictions on advertisement by indiv CAs
- Part I, First Schedule of Chartered Accountants Act, 1949
 - No solicitation of clients or professional work by advertisement
 - No professional attainment or services can be advertised
- Network affiliates which are not CA firms not bound by restrictions on advertisement - non-level playing field
- Australia, US: Allow advertisement for solicitation of work subject to conditions:
 - Advertisement cannot be false, misleading, or deceptive.
 - No exaggerated claims
 - Must not indulge in disparaging references or unsubstantiated comparison to the work of others
- **Reco 4.5: CAs and CA firms should be allowed to advertise to solicit work subject to conditions (p. 61)**

Section 7

Conflict of interest

Audit v. Non-audit services

- Auditors resolve *agency problems* between owners & managers of company
- Auditors must be independent of the auditee company
- Independence likely to be compromised if auditor receives fee from the auditee company for non-audit services
- *Enron case*: Andersen received \$25 million in audit fees and \$27 million for non-audit services
- World-over this *conflict of interest* is addressed through regulations
- *Sarbanes Oxley, 2002*:
 - Prohibited a list of non-audit services
- Similar prohibitions in UK, EU, Australia, India

Audit v. Non-audit services

- Europe regulates audit to non-audit fee ratio
- Europe: non-audit fees can be up to 70% of the average audit fees in last three years
- **Reco 4.6:** If auditor part of an international network, non-audit fee of network to be max 50% of the audit fees earned by a network from a company and its group. (p. 65)
- **Reco 4.6:** Include non-audit services like taxation, valuation and restructuring in list of prohibited services
- **Reco 4.6:** Audit committee or Board's approval to engage auditor for non-audit services must be disclosed in board report along with necessary safeguards to protect auditor independence
- **Reco 4.6:** Necessary rules to be made

Section 8

Liability of auditors, firms and networks

Current liability regime

- Limitations in CA Act, 1949 exposed by *Satyam* (p. 42):
 - ① Monetary penalty only up to Rs. 5 lakhs on indiv CA
 - ② No action possible against the CA firm
 - ③ No action possible against the network
- Position under Companies Act, 2013 with NFRA (p. 40-41):
 - ① Monetary penalty on individual CA - 5 times the fees
 - ② Monetary penalty on CA firm - 10 times the fees
 - ③ Individual CA/firm can be debarred from 6 months to 10 years
 - ④ No network liability

Findings u/4.7: Adequate liability on CAs, CA firms - no network liability (p. 71)

Network disclosure

- EU and UK require Annual Transparency Report to be submitted by audit firms (p. 78)
- Indian member of international networks must submit to NFRA an **Annual Transparency Report** disclosing: (**Reco 4.7** pp. 71-73)
 - ① description of the network, legal and structural arrangements, including payment of any fees, costs, grants etc
 - ② details of ownership and management structure of the outside entity constituting the network
 - ③ name and registered office, central administration or principal place of business, of each network member (sole practitioner or audit firm) and of each affiliate operating in India
 - ④ total turnover achieved by the auditors operating as sole practitioners and audit firms as well as network affiliates that are members of the network
 - ⑤ internal standard audit processes and procedures followed by all the network firms globally and in India

Network liability

- **Reco 4.7:** Penalty for audit failure or fraud due to faulty procedure at international network level
- **Reco 4.7:** International network entity liable upto 5 times the penalty amount imposed on the network member firm(s)

Section 9

Company not to practice as CA

Section 25

- Section 25: Companies not to engage in practice as CAs
- S. 2(2) deems an ICAI member to be in practice if she engages in activities mentioned u/s. 2(2)(i)-(iv)
- S. 2(2)(i)-(iv) does not prohibit any lay person from performing those activities
- CA's exclusive right to practice comes from laws like Companies Act, 2013, Income Tax Act, 1961 etc - not from CA Act, 1949
- Eg. a company can provide professional services relating to accounting - s. 2(2)(iii)
- However, a company cannot practice as CAs
- Signing by a partner (sec 141(2), 145, ICAI's announcement)
- **Reco 4.8:** A CA must be prohibited from signing as such on behalf of any company (p. 79)

Section 10

Reciprocity

Section 29

- A foreigner is eligible to become member of ICAI only if such foreign country does not prohibit or discriminate against Indians from becoming CAs there
- Network audit firms in India are Indian firms
- They have Indian partners
- Those Indian partners are members of ICAI
- **Reco 4.9:** No question of reciprocity arises in this case

Section 11

Multi-Disciplinary Practice (MDP)

- Industry associations and corporates prefer one-stop service provider - MDPs
- Companies Act, 2013: S. 141(1) envisages MDPs
- Chartered Accountants Act, 1949: amended in 2012 to allow CAs to form partnerships with members of other recognised professions
- Chartered Accountants Regulations, 1988: Regulations 53A and 53B allow fee sharing as well as sharing of services among CAs, CS', cost and work accountants, advocates, architects and actuaries
- Issues under Advocates Act, 1961
 - Complaints by SILF against audit firms
- Yet, law firms and audit firms expanding their portfolio of services to cater to industry demand

MDPs in other jurisdictions

- UK introduced Alternative Business Structures (ABS)
- Regulated by Legal Services Board
- Main advantage: promote non-lawyers, access to external financing
- **Reco 4.10**: MDPs should be facilitated by rationalising Advocates Act, 1961 (p. 83)

Section 12

FEMA

FEMA

- Allegation - PwC invested Rs 41.42 cr through PwC, Kolkata to acquire Dalal & Shah (p. 13, SC judgement)
- Interest free loan/non-refundable grants
- FDI route - no restriction (FEMA 20, Reg 15 r/w Reg 16)
- ECB route - no person resident in India shall borrow or lend in forex (FEMA 3, Reg 3)
- Non-refundable grant not same as 'borrowing' or 'lending' u/FEMA 3
- Non-refundable grant - seemingly current account transaction (sec 2(j), FEMA Act, 2000)
- Reply awaited from RBI