Report on regulating audit firms and the networks

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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)]

Recommentation 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
  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
  - with Indian partners (p. 56)
  - partners members of ICAI (p. 56)
  - 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
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 indv 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 indv 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 up to 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
- 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