What is suddenly sending shivers down the spines of 350,000 CAs?

By Vanita Bhatnagar

A young and feisty regulator that is coming for them

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Vanita is a lawyer by training and writes stories at the intersection of business & public policy, law, regulations and building inclusive workplaces.

HIDE SUMMARY

- Since 2022, NFRA has debarred 78 auditors and has imposed Rs 16.6 crore in penalty
- Earlier during ICAI, only 25 rogue auditors faced action in over a decade with around 1,400 cases pending
- The clampdown from regulatory authorities has caused fear among the auditors, leading to a spurt in their resignation
- So much so that CA resignations have shot up 4.3X in five years to March 2022. And the problem is rooted in their scope of work

Auditors are having a horrid time, and they have a new watchdog to thank for that.

In April, the National Finance Reporting Authority (NFRA) levied penalties worth Rs 4.5 crore (US$539,000) on auditor Messrs Pathak H.D. & Associates and two chartered accountants (CA) for failing to meet standards in their audits of mid-size non-bank Reliance Capital Ltd.

The exemplary penalty—the highest ever levied since 1949—imposed by the six-year-old regulator was meant to serve both as a deterrent and a warning to audit and accounting professionals.

This has sent shivers down the spines of 350,000-plus registered CAs, whose job is to audit financial statements and provide financial guidance to businesses.

"There is risk, there is fear, and not many people want to practice chartered accountancy anymore," mumbled a senior associate from Deloitte. They and six others requested anonymity as they either feared commenting on a government regulator publicly or were not authorised to speak with the media.

From the state-funded non-bank Infrastructure Leasing and Financial Services Limited (IL&FS) to India's first edtech unicorn Byju's, the cry after each debacle was *'where were the auditors?'*

No one asked who was on the board, who was the independent director, who was the banker, who was the adviser. Everyone just wanted to know who the auditor was.

"We are seen as providing insurance against corporate failure but that is not our job," said the Gurgaon-based CA from Deloitte quoted above. "We are not Lord *Brahma* who knows everything about what is happening in the company."

All of the five auditors *The Ken* spoke with argue that the company executives are responsible for the accuracy of the financial statements and that the role of the auditors is only to obtain "reasonable assurance and not a guarantee" that a finance statement is free from material misstatement.

> *The norm for auditors was to be watchdogs and not bloodhounds*
>
> CA WORKING WITH AN AUDIT FIRM PENALISED BY NFRA

Auditors work in a typically conflicted environment. They are agents of two principals: the client (the firm being audited) and the public. The law expects statutory auditors to be independent, keep a check on clients for mistakes and flag them, and if everything is in order, sign off the balance sheet with that golden signature—all this while, getting paid by their clients.

Therein lies the problem.

"I am a bit critical of the auditing community; they have not done enough work on maintaining the sanctity of the accounting process," said Neerav Nagar, associate professor of finance and accounting at the Indian Institute of Management, Ahmedabad (IIM-A).

There was a spurt in auditor resignations only after the Satyam episode when a Big 4 audit firm was penalised, he added. "And sometimes auditors leave without giving any justification, the reasons for which include time or budget pressure, competition in the audit market, conflict of interest, etc."

"Note that they may also be rendering other services (e.g., consultancy) to the same client or a firm within the client's business group," said the professor whose areas of research are include financial reporting, corporate governance, earnings manipulation and fraud detection.

That ends up being a skewed dynamic. While they are expected to be sceptical and ask tough questions from their clients, the client prefers auditors who toe the line, said Advocate Sunil Aggarwal, standing counsel in Delhi High Court and ex senior Partner at AZB & Partners. Plus, even the auditors want to be on the side of the clients so that they can retain and win newer clients (via recommendation).

But now, the sector is undergoing a shake-up as the new, independent audit regulator—the NFRA—is keen on proving that it's different from the 75-year-old self-regulated body of auditors—the Institute of Chartered Accountants of India (ICAI). Since 2022, the NFRA has debarred 78 auditors and imposed Rs 16.6 crore (US$2 million) in penalties. On the contrary, only 25 errant auditors faced action from ICAI in more than a decade.

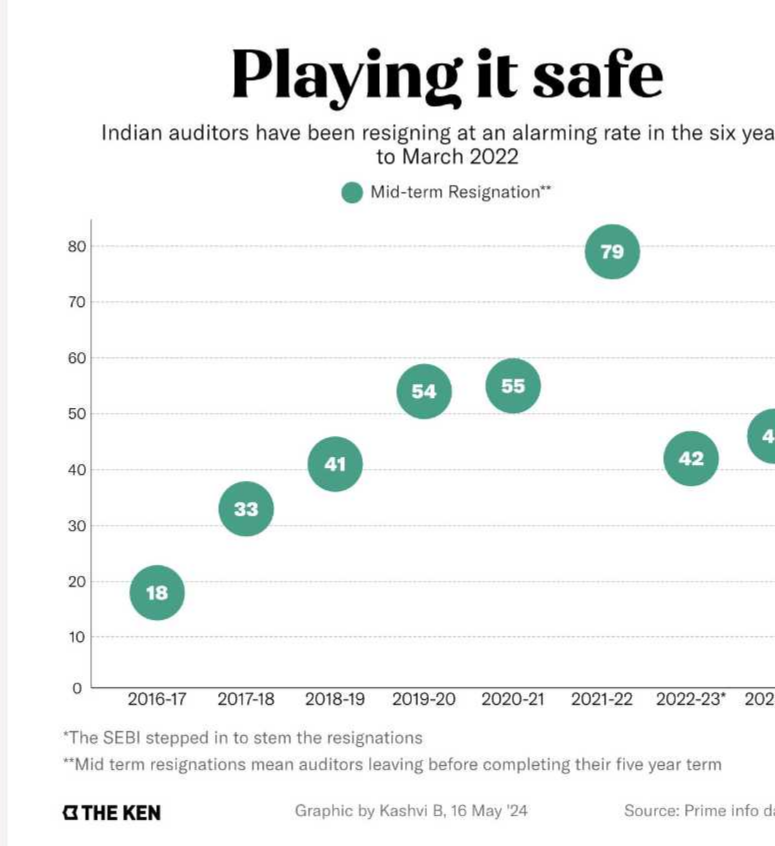
This comes at a time when both public and private companies have been mired in financial irregularities.

Last June, the Indian arm of audit and taxation firm Delloite Haskins and Sells resigned as the statutory auditor of Byju's, cutting short its five-year term due to non-cooperation from management. The once superstar edtech lost US$20 billion in valuation due to the alleged accounting irregularities and purported mismanagement—something the auditors should have flagged during their term.

Since 2022, there have been many such cases of financial irregularities in startups, including Bharatpe, Go Mechanic, Broker Network, Trell, and Zilingo, where the companies were accused of inaccurately reporting financials.

While the NFRA's order in the case of Reliance Capital suggests an epochal shift for the auditing sector, the litigation and reputational risks hanging over the auditing professionals and firms are keeping new talent away from this profession.

As for the existing ones, "resigning seems the safest bet", remarked another Mumbai-based CA, who also resigned as a statutory auditor from a listed company. So much so that CA resignations shot up 4.3X in the six years to March 2022.



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A large part of the reason for this standoff between auditors and the regulator lies in the scope of the auditors' job.

Why don't auditors find fraud?

"As auditors, our job is only to give an opinion on whether the accounts are a 'true and fair' representation of reality, flag misstatements, and consider the risk of fraud. Not to hunt it down," said a practising CA working at one of the audit firms that have been penalised by the audit regulator.

For instance, Reliance Capital, with a revenue of nearly Rs 19,000 crore (US$2.2 billion), was jointly audited by a decade-old Delhi-based auditor Price Waterhouse & Co LLP and Pathak H.D. & Associates, a Mumbai-based boutique chartered accountancy firm with four designated partners.

An NFRA member told *The Ken* that they acted after getting a letter from the Ministry of Corporate Affairs (MCA) in May 2020 that Price Waterhouse suspected fraud at Reliance Capital regarding loans and investments amounting to about Rs 12,500 crore (US$1.5 billion) to some group companies.

Price Waterhouse refused to sign the audit report and resigned as a statutory auditor. As for the other auditor Pathak H.D. & Associates, neither could it find any fraud, nor did it carry out any independent procedures on these matters. Instead, it issued the audit report with a qualified opinion.

The Ken reached out to the NFRA, the ICAI, Reliance Capital, and Deloitte but did not receive a response from them.

But the CA quoted above said such failures may not always be detected by auditors. For one, a company's books are so vast that audits can only realistically assess a sample of transactions in selected markets.

"Better data-analysis techniques allow for larger samples and better anomaly detection," they said. Auditors, however, do not leverage them. "For large companies, looking at less than 5% of transactions is the norm."

Another reason audits can differ from firm-to-firm is that accounting treatments are subjective even if the data being treated is the same set (read: numbers and spreadsheets). Bonafide differences in estimates of value in financial statements do not constitute fraud or misreporting in financial statements and therefore NFRA may not have any role in them, explained Aggarwal.

That's because accounts contain plenty of assumptions. Auditors must think on their feet to analyse the rationality of those assumptions. They could be wrong because information can even emerge after the audit.

"For instance, loan disbursements are treated as assets under the balance sheet during audits. But if the company fails to recover such loans, they are written off," said the Deloitte CA quoted above.

Those few audits end up defining the auditor involved as errant, they added.

The regulators feel differently though. They believe auditors must maintain governance even more than the promoters; but auditors worry this will impact their client pipeline, said the CA.

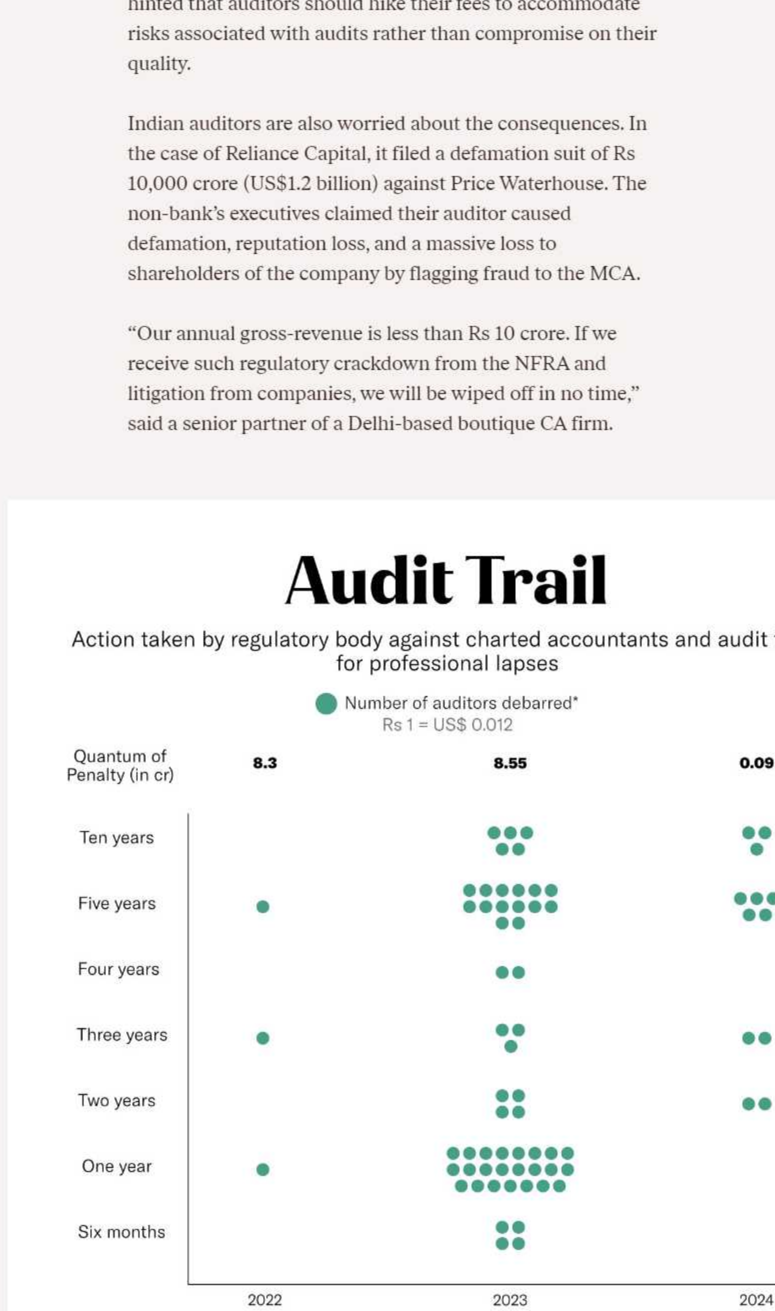
"It is impossible for us to conduct such an extensive audit in every single case given our current fee structure." Companies listed on the National Stock Exchange (NSE) typically paid audit fees of Rs 1.5–3 crore (US$180,00–360,000) for the financial year of 2023. However, a forensic audit that investigates financial misconduct, costs 3X a regular audit.

They also can't afford to spend that kind of time on every audit as auditors are expected to sign the balance sheet and prepare the audit report at the end of a financial year.

But one man's risk is another man's opportunity. In a recent NFRA conference, its chairperson Ajay Bhushan Pandey hinted that auditors should hike their fees to accommodate risks associated with audits rather than compromise on their quality.

Indian auditors are also worried about the consequences. In the case of Reliance Capital, it filed a defamation suit of Rs 10,000 crore (US$1.2 billion) against Price Waterhouse. The non-bank's executives claimed their auditor caused defamation, reputation loss, and a massive loss to shareholders of the company by flagging fraud to the MCA.

"Our annual gross-revenue is less than Rs 10 crore. If we receive such regulatory crackdown from the NFRA and litigation from companies, we will be wiped off in no time," said a senior partner of a Delhi-based boutique CA firm.



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But regulators have no patience for auditor's concerns.

Auditing the auditors

Regulators believe finding out fraud is part of evaluating a company.

"How can an auditor ensure the contents of the financial statements are 'true and fair' unless they have properly investigated the company," said Aggarwal.

Like in the case of Reliance Capital. Despite the evidence of documented irregularities, the other auditor, Pathak H.D. & Associates, did not question the management about the recoverability of the sanctioned loans. It should have considered the chances of the non-bank failing at recovering loans, how the borrowing company was using this money, the genuineness of the transactions or if the promoters were just routing out the money.

"If auditors provide a true and fair view like the way Pathak H.D. & Associates did in Reliance Capital, we will have to step in and audit them," said the NFRA member quoted above.

> *We are not asking auditors to investigate. Nor are we asking them to expend lots of resources to go out and get specialists. All we urge is when you see things of concern, don't just unsee them; rather flag them*
>
> NFRA MEMBER

Trust but verify should be the auditors' motto, they said.

Technology, and not sample-based auditing, is the key, they added. "Auditors have to give assurance of the whole balance sheet and not 5% of transactions which they sampled and worked on".

Who is accountable

An MCA official told *The Ken* these actions may appear sudden. However, the aftermath of the IL&FS crisis made the need for having an independent regulatory like the ones in countries such as Singapore and the US body crystal clear.

But setting up the NFRA wasn't easy, courtesy of the stiff opposition from the accountants because of the strong accountant lobby, they added. Prior to its establishment, the ICAI could only rule on accountants' professional misconduct; it did not have jurisdiction over CA firms, something which the NFRA now has.

> **Internal affairs** // According to an experiment run by two IIM-A professors (Prof. Naman Desai and Prof. Neerav Nagar), when clients were only listed in India, auditors identified the fraud risk but preferred not to report them. However, where companies were cross listed in both the US and India, they considered issuing a qualified audit report, fearing the legal consequences emanating from the US, a country with a strong legal regime and enforcement. So, auditors' behavior is also shaped by the regulations and enforcement in the country they operate in

Amarjit Chopra, former president of the ICAI and senior partner at Delhi-based audit firm GSA Associates and LLP, has a radical suggestion. The government should appoint auditors for the listed companies instead—or better, nationalise the profession, he said.

IIM-A's Nagar said that currently, there is no mechanism to determine the quality of the audit, if the process was followed by the auditor, and whether the auditor was qualified enough to investigate a company.

To fix this, the NFRA is introducing better disclosure. Auditors of the top 1,000 listed companies by market capitalisation must submit annual transparency reports along with the financial statements for the year ended March 2023.

In such reports, the watchdog intends to mandate publishing critical information on the auditor's operational activities, governance, management, and ownership structures, along with policies and procedures necessary to deliver high-quality audits.

"For decades we have been operating like this, where raising a red flag was not a norm. It was uncommon to even issue qualified or adverse reports," said the CA from Deloitte.

"But now the course has to change."

With inputs from Aakriti Bhalla

(Update: An earlier version of the story misquoted Neerav Nagar, the associate professor at the Indian Institute of Management, Ahmedabad. It has now been corrected; The Ken regrets the error.)