

Audit fees must be fair to ensure quality and no overdependence

It should be high enough for auditors to do the job well but not so high that their independence is hit



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Auditors for years have lamented low audit fees whenever audit quality is questioned by regulators, the government or other stakeholders. Data released by Prime Database and other sources on audit fees paid by listed entities suggests a meagre increase of 6% in 2022-23 and about 28% over the 2018-23 period.

Audits serve the public interest and are relied upon by investors, lenders and others while making investment decisions. It is difficult to fathom such a meagre increase. It doesn't match even the general 10-15% increase that employee salaries see every year. The situation for unlisted companies and for medium and small size firms is worse.

Audit firms lack the resources needed to invest in technology-based audit tools, build multi-disciplinary expertise, upgrade skills and recruit as well as retain talent as a *sine qua non* for quality audits. Irrespective of their size, these firms cannot pay competitive salaries and are facing an exodus of chartered accountants, who are joining industry or consulting firms. Auditing is no longer a preferred career option for many young chartered accountants.

Inadequate audit fees could lead to either a compromise in due diligence exercised during audit processes, or an impairment of the audit firm's independence in carrying out audit work, as it may make them seek the favour of

non-audit assignments from clients to boost overall earnings and compensate for low audit fees. Disciplinary orders issued or inspections of audit firms conducted by the National Financial Reporting Authority (NFRA) point to: (a) inadequate capacity, competence and capability among audit firms in terms of knowledge, use of tech-based audit tools commensurate with the size and nature of audit clients and audit risks involved; and (b) compromises on audit independence that raise conflicts of interest and other ethical concerns.

When an audit firm accepts audit work at a low fee, it survives financially by reducing the effort on audits or by compromising its quality. As audits are a matter of public interest, this is a worry. The adequacy or otherwise of audit fees must not be an excuse for any audit firm to compromise quality.

Ironically, quality auditing in India does not command the premium it deserves. Many companies do not see value in the process, treating it as no more than a statutory requirement. The Securities and Exchange Board of India (Sebi), Reserve Bank of India (RBI), NFRA and institutional investors in recent years have taken measures to enforce audit quality by strengthening the role and responsibility of the board of directors, independent directors, audit committee and auditors. The increased rigour of regulations and supervision in recent years has sensitized managements, boards and audit committees to the need for reasonable audit-fee payouts. This, however, has not raised audit fees by much. In contrast, the audit fee of firms in the US after their registration with the Public Company Accounting Oversight Board, an audit regulator in the country, has seen a significant increase. Hopefully, the role being played by NFRA will have the same effect in India.

Higher than reasonable audit fees is as bad as low fees. High fees may make audit firms more financially dependent on clients, which could lead to their

reluctance in making appropriate inquiries and asking difficult questions during the audit process. It is thus important to ensure that audit fees are always reasonable, neither too high nor low. The responsibility for this lies with audit firms themselves, apart from audit regulators, audit committees and other stakeholders at large.

An audit firm, before accepting an assignment, should estimate the cost and effort involved and resources required for the task. The company's audit committee, while determining the audit remuneration, should discuss with the audit firm its own assessment of the time, effort and resources required, taking into account the size and complexity of the company's operations and the basis on which the auditor has quoted its fees. In addition, the company's annual report should disclose, among other things, the methodology adopted by the audit committee to satisfy itself on the audit fee. The NFRA, while carrying out its inspection of audit firms (and during disciplinary proceedings if any), should look into the basis for fixing fees and their revisions to check their reasonableness. High or low audit fee should raise red flags as they may *prima facie* indicate a possible quality problem. Such an approach will deter audit firms from undercutting one another and companies from selecting an audit firm that charges especially low fees. The cardinal principle is that an audit firm should not accept an audit job at a fee that is not sustainable, and the company shouldn't appoint an audit firm at a remuneration that will not enable it to meet quality standards.

It is imperative that audit firms invest in people and technology. Audit fees are their only available source of funding, and if it is unreasonable, audit quality may suffer. Allowing audit firms to raise equity finance is a questionable proposition and is beset with practical difficulties. If Indian audit firms are expected to go global, among other things, they need to be paid audit fees by global standards.