The Audit Profession

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The Enron-induced problems for Andersen have lead to soul searching in the audit profession. What is the likely scenario in the years to come?

1 **Segregation of Audit from Consulting**

Arthur Levitt Jr, Chairman of the Securities Exchange Commission deserves credit for his prescience in highlighting several years ago that consulting activities could compromise audit independence. Levitt was of the view that audit firms should offer consulting services only to parties who are not their audit clients.

A few consulting / audit firms saw the way the wind was blowing. Ernst & Young, for instance, sold its consulting division to Cap Gemini. Most others resisted these moves. *Now the split between consulting and audit will happen without a whimper. This could even lead to a certain re-direction of business flows in favour of non-audit backed consulting organizations.*

Incidental to this, a clear view would need to be taken on certain grey areas. For instance, advise on income tax matters, opinion on other regulatory issues, certification work mandated by statute etc. These are not strictly related to statutory audit. Would they be deemed as consulting work? Are we talking of three lists –

- One, which will be handled by auditors as part of the statutory audit;
- Two, which can be handled by auditors, but subject to certain safeguards;
- Three, any other service, which would be a no-no as far as audit clients are concerned.

In the meanwhile, the Institute of Chartered Accountants of India (ICAI) does not want consulting fees of the auditor to be higher than audit fees. *This step by itself may not be adequate.*

2 **Responsibility Levels**

Audit firms' responsibilities as a watchdog are bound to increase. The consequences of negligence in these responsibilities too are going to be stiff. These are likely to lead to–

a. Greater knowledge sharing within the firm and a trend towards taking a conscious "*firm view*" on most issues, in particular ambiguous issues. More the number of partners, greater would be the need for knowledge management systems that would facilitate this.
b. Closer supervision of audit work within the firm, backed by detailed listing of audit processes.
c. The organisation structure of audit firms too may evolve. We may see the emergence of a stronger staff function. This would comprise people who offer better value in generating the "firm view" and / or who lack the requisite supervisory skill sets for the audit work.

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d. An independent monitoring role is likely to emerge within audit firms, to ensure the compliances inherent to audit. This role could be given the politically correct nomenclature of "*audit quality assurance*".

In India, the increase in responsibility level throws up a ticklish issue. Partnership firms operate on the principle of unlimited liability. Where does that leave other partners if one partner acts negligently? *It is time for a new partnership act with facilitating provisions for 'limited liability partnerships (LLPs)' of the type seen abroad.*

3 **Insurance**

We can expect greater appreciation of the risk of third party claims in the audit profession. Insurance companies will target auditors with as much vigour as they target doctors. *Some sort of grading of auditors based on track-record and systems too is not too far-fetched.*

The nature of the legal system would ensure that this change hits India much later than some of the other changes envisaged here.

4 **Appointment of auditors**

The legal position is that shareholders appoint auditors. Reality is that the management of the company is a key influencer. Why would management of any company not propose re-appointment of a "convenient" audit firm? Further what happens when the management of the company has a majority shareholding? Can they appoint any auditor, irrespective of the minority shareholders?

As a corporate governance measure, we may see *statutory auditors being proposed for appointment by independent directors of the Board* in public companies.

Further, *compulsory rotation of auditors every 3 years* too may be an option. In such a situation, the new auditor may not have the benefit of the previous auditors' experience. But at least there would be the benefit of a fresh mind every 3 years. In the year of changeover, the auditor can even review the previous auditor's work. Thus, *peer review becomes a byproduct of the system.*

5 **Auditors' Reports**

One of the powerful weapons in the hands of the auditors is qualification in their report to the shareholders. Auditors have tended to use this weapon sparingly. When this changes, Auditors' Reports of companies will no longer be bland and similar. They will become interesting reading!

6 **Fee levels**

Not everything is gloomy for auditors. All the above changes will come at a price – and auditors can extract it. Audit fees will shoot up. For a change, shareholders will not complain when the resolution on auditors' appointment and remuneration is moved in the Annual General Meeting. But *Auditors will be expected to deliver. If they don't, they will pay a much higher price.*