FFIAR
Forum For Indian Accounting Research

10 November 2021

The Secretary,
National Financial Reporting Authority
7th-8th Floor, Hindustan Times House, 18-20,
Kasturba Gandhi Marg, New Delhi 110001.

Dear Sir/Madam:

We compliment NFRA for this initiative of seeking feedback/responses on a matter that could enhance the ease of doing business in India.

On behalf of the Forum for Indian Accounting Research, a not-for-profit organization that brings together academicians and practitioners to foster high-quality Accounting research in India, we are pleased to submit our responses to the Consultation Paper on Statutory Audit and Auditing Standards for Micro, Small and Medium Companies (MSMCs).

We thank NFRA for this opportunity to present our comments.

Sincerely,
Professor, KV Achalapathi, former President, Indian Accounting Association
Professor Sanjay Kallapur, Indian School of Business
Professor Hariom Manchiraju, Indian School of Business
P R Ramesh, ex-Chairman, Deloitte India
Professor Srinivasan Rangan, IIM Bangalore
Professor Srinivasan Sankaraguruswamy, National University of Singapore

Response to questions

1. *Do you think that Micro, Small, and Medium Companies (MSMCs) depending upon some criteria and threshold should be exempted from the mandatory statutory audit under Companies Act, 2013? If not, why not and if yes, what would be the criteria and thresholds for exemption?*

   Response:

   We start with the premise that the benefits of regulations must clearly exceed the cost of complying with them, not just on average but in the maximum number of cases. Because costs and benefits are likely to vary across individuals, they are in the best position to determine what is best for themselves. Some small firms may have a need for an audit because of their special situations such as having dispersed owners or debt, while others may not. Indeed, the auditing profession in the UK and the USA came into existence long before there were any regulatory mandates for audits, suggesting that companies voluntarily purchase audit services when they find that its benefits exceed costs.[1] But regulation necessarily takes a "one size fits all" approach, at least within each category to which it applies. Therefore a regulation for mandated audits is a blunt instrument that needs to be used sparingly in the case of non-publicly-listed MSMCs.

A second consideration is whether the parties that stand to benefit from a requirement can enforce it themselves. For example, lenders who benefit from audits are able to force it by refusing to lend in the absence of audited financial statements. Therefore, regulation is warranted only where there is a public interest (of non-contracting stakeholders), or a need to protect contracting parties who cannot protect themselves due to contracting frictions. For example, being dispersed which constitutes a contracting friction, small shareholders in a publicly listed company have little ability to require audits even if they see the benefits of it.

In the UK, private firms were required to be audited prior to 1994 but audits were made voluntary for very small private firms in 1994, and for larger private firms in 2004. Research in accounting has examined this change, and found that over 62% of the larger private firms newly exempted in 2004 continued to get themselves voluntarily audited.[2] The ones that chose to get audited were exactly the ones for whom benefits of audits were likely to exceed costs—firms that are larger, have more dispersed shareholders, have more inventory and receivables that are typically red flags for low-quality earnings, and that intend to raise capital. Interestingly, the voluntarily audited firms had lower profitability and lower interest coverage, suggesting that it is the contracting parties' need, and not affordability by the firm, that drives the decision to get voluntarily audited.

Other research in the UK context[3] shows that there is another benefit of making audits voluntary. It enables the better firms to signal that fact by their decision to get audited: the credit ratings of the firms that voluntarily chose to be audited increased. Since these firms were already being audited (it being mandatory) the increased credit rating cannot be due to the assurance effect of an audit and is therefore purely due to the signalling effect mentioned above, something that is not possible under mandatory audit. Overall, the research therefore suggests that firms' decisions to get audited are in accordance with the theory outlined above, implying a limited role for a mandatory audit regulation for MSMCs.

As the Consultation Paper notes, the general-purpose financial statements that auditors attest are primarily meant for the benefit of contracting parties. In view of the above considerations, we think that exempting MSMCs that are not publicly listed is a

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[1] Watts, R. L, and J. L Zimmerman. 1983. "Agency Problems, Auditing and the Theory of the Firm: Some Evidence." *Journal of Law and Economics* 26: 613–33.
[2] Dedman, E., A. Kausar., and C. Lennox. 2014 "The demand for audit in private firms: Recent large sample evidence from the UK" *European Accounting Review*, 23, 1-23.
[3] Lennox, C., and J. Pittman. 2011. "Voluntary Audits Versus Mandatory Audits". *The Accounting Review*, 86, 1655-1678.

step in the right direction. It would be consistent with the world-wide practice, as noted in the Consultation Paper.

However, it would be prudent to proceed in steps and phase in the implementation, as was done with IndAS. For that purpose, we note the following statistics provided in the Consultation Paper.

The data on the estimated audit cost as a percentage of profit before tax (Consultation Paper Table 1.7) indicates that this percentage is higher for companies having low turnover. Using a standard benchmark of 5% for materiality, we believe that costs of auditing are highly likely to exceed benefits for firms with revenues below ₹ 10 crores. An audit fee greater than 5% of profit seems onerous to small firms that are seeking to grow.

Therefore, to start with, all companies with less than ₹ 10 Crores turnover should be exempted from audit. This will immediately benefit 507,262 of the 566,935 private limited companies in 2018-2019, or about 89% (Table 1.4).[4]

After evaluating the experience with this group, the requirement can be progressively relaxed further in stages, preferably with those stages announced in advance.

2. *Do you think there is a requirement for a separate set of auditing standards for MSMCs as it exists for accounting standards? If no, why not and if yes, what should be the basis for the same?*

Response:

We believe that having separate auditing standards will cause unnecessary confusion. People understand the difference between audited and unaudited financial statements, and with some minimal degree of sophistication they would also understand different accounting standards. For example, a company that chooses to voluntarily comply with IndAS even if it is not required, could mention that fact and be understood. However, it would take a very high degree of sophistication in accounting and auditing, that is unlikely to be found even among most MBAs, to understand the difference between different auditing standards. So the multiplicity of auditing standards will create unnecessary confusion.

Moreover, we believe that the effort associated with auditing is primarily driven by client size. Compared to client size, compliance with audit standards is likely to have a much lower impact on auditor effort and the related costs. Hence we recommend against issuing different auditing standards for MSMCs.

3. *The cost of conducting an audit as per the prescribed standards is an important input for the responses to Questions 1 and 2. Do you agree with the approach for estimating standard cost of audit computed by NFRA? If not, which areas/ assumptions need changes?*

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[4] 507,262 =25,756+73,648+34,359+38,900+1,36,914+197,685

Response:

Overall, the approach taken seems reasonable. We agree with the conclusion that audit fees reported by many companies in the range of under ₹25,000 is clearly substantially below what it would cost to do a proper audit. However, the actual effort of staff and partners will depend on factors such as the number of transactions and their complexity, as well as the complexity of the accounting issues involved.

Our only additional comment is that in the "Supporting Details for Cost Estimation" section, we believe that the estimate of Partner hours at 45% of field hours seems high. We suggest reducing this percentage to 20%. Costs recalculated on that basis would be more accurate.

4. *Do you think the current exemption thresholds for CARO, ICFR and statutory audit applicability need to be standardised and made uniform? If no, why not and if yes, what would be the criteria and thresholds?*

Response:

A basic requirement of ICFR is segregation of duties, which involves additional staff. Therefore, CARO and ICFR involve substantial additional cost. We think that there could be many situations where public interest requires a mandated audit, but ICFR might nevertheless not be cost-effective. Therefore, we suggest retaining separate thresholds for the two sets of requirements.