

## **Auditing Standards & Ethics Committee's Opinion**

### **Enquiry on reconsideration of ICAP technical opinion on appointment of one auditor in place of two retiring auditors**

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The Auditing Standards & Ethics Committee of the Institute received enquiry regarding:

Reconsideration of ICAP opinion issued on March 6, 2020 on appointment of one auditor in place of two retiring auditors.

The enquirer apprised following additional information and details regarding Company's policy in respect of appointment of Statutory Auditors and the actual objective behind their intent to switch from joint auditors to a single auditor in order to assist the Technical Committee for re-consideration of their opinion:

#### **1) Existing Policy on Appointment of Joint Auditors:**

- a) Selection of Auditors only from internationally affiliated Big 4 Firms on fixed fee basis.
- b) Change of Auditors every 6 years with change of partners every 3 years.
- c) Both the Auditors shall not be changed simultaneously.

#### **2) Switching to Single Auditor Approach:**

The Company intends to switch over to a single audit firm considering the following factors:

- a) Ease of external audit management through a single auditor vis-a-vis joint auditors and avoidance of duplication of work, without compromising on corporate governance.
- b) Major listed companies in Energy sector have single auditor except OGDCL.
- c) Exorbitant fee quoted for other allied assignments forming integral part of the statutory audit e.g. review of valuations, ECL model and other disclosure requirements upon applicability of new IFRS etc.
- d) Assignment of other audit engagement services such as Audit of Retirement Funds, CSR & Board of Management (BoM) Financial Statements, WPPF and Secretarial certifications as required under various Statutes/ Trust deeds etc. to incoming single auditor.

#### **3) Technical Qualification:**

Quality Assurance remained the Company's top priority both in case of joint auditors and also while switching to a single audit firm, only 4 Big Audit Firms will be considered as technically qualified to participate in the hiring process for the appointment of a single auditor and these firms are being requested by the Company to submit their sealed bids for Financial Years 2021-2023 within a defined period as per the Terms of Reference duly approved by BoM.

#### **Points for Consideration:**

- i. Spirit of under-cutting principle is that any company does not compromise on quality of audit for a probable fee reduction. In our view, based on above facts, the under-cutting principle is not directly applicable on the Company, considering that these audit firms are already pre-qualified and hence there is no possibility of quality compromise.
- ii. At present, the Company has a joint audit arrangement wherein the audit fee is equally paid to both the audit firms. After switching to single auditor, as per above referred ICAP's opinion, the single audit firm's fee cannot be lower than the composite fee previously been paid to joint Audit Firms.

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This aspect of ICAP's earlier opinion needs to be re-visited as under the prevailing auditing standards, a major portion of the work is being done in full (including review of Financial Statements and other deliverables) by both the Audit Firms. Hence, it appears strange that an incoming single audit firm will get composite audit fee without making any significant effort or any major shift in the scope of their work, except that now the report will be signed by a single audit firm instead of joint Audit Firms.

In our view, capping shall be made applicable on a minimum fee taken by an individual audit firm in a joint audit arrangement instead of capping on composite audit fee.

#### iii. Other Audit Engagements (Point 2d):

In addition to Statutory Audit/ Half yearly reviews, ICAP's opinion is also requested that whether the under-cutting principle and capping on last Year's fee is also applicable on other audit engagements as well.

### The Committee's views and conclusion

1. The Auditing Standards & Ethics Committee of the Institute (the Committee) considers the audit and ethics related matters and issues its opinions after consideration and analysis of:
  - The particular facts and information provided in each enquiry; and
  - The requirements of the International Standards on Auditing as applicable in Pakistan (ISAs), the Code of Ethics for Chartered Accountants (ICAP Code of Ethics), and audit and ethics related provisions of the Companies Act, 2017 (the Companies Act).
2. The Committee based on the fact pattern mentioned in your enquiry understands that the company intends to appoint a single statutory auditor. While in the prior year(s) the company had appointed joint statutory auditors.

In this context, the Committee's analysis and response to the enquired matter is based on the parameters outlined in paragraph (1) above, and does not include study or evaluation of the legal and statutory obligations and internal policies applicable to the company.

3. The Committee considers it pertinent to mention that the members of the Institute are regulated under the Chartered Accountants Ordinance, 1961 (the Ordinance).

The Ordinance prescribes "undercutting" as a professional misconduct. Relevant provision of the Ordinance is reproduced below:

*"A Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, if he accepts a 'position as auditor' previously held by some other Chartered Accountant in such conditions as to constitute undercutting."*  
(underline is ours)

4. Under the Companies Act, companies are required to appoint their statutory auditors.

In the position of a statutory auditor, consequent to and under the requirements of the laws applicable to the appointing company, an auditor besides audit of financial statements is also responsible for the review of financial statements and other audit/certification engagements that can only be performed by a statutory auditor.

5. The members of the Institute are also required to comply with the ICAP Code of Ethics.

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ICAP Code of Ethics based on the above statutory requirement of the Ordinance sets out following principles for establishing the audit fees:

- a) Auditor may enter into fee arrangement(s) which they deem appropriate, commensurating to the size, scale and scope of the audit engagement. Accordingly, when entering into negotiations regarding professional services auditor can quote whatever fee he/she deems appropriate.
- b) Owing to the provision of the Ordinance which holds 'undercutting' as a professional misconduct, an auditor cannot accept an audit at a fee lower than the previous year's audit fee.

However, above restriction has an exception. An auditor can accept an audit at a fee lower than last year's audit fee, when such auditor determines that scope or quantum of work is materially reduced from the scope or quantum of work carried out during the previous year's audit.

The principle of undercutting therefore requires that the auditor should not reduce the audit fee from the last year. However, equally important is the evaluation of specific facts and circumstances of each engagement to determine whether lowering of audit fee constitutes undercutting or not.

6. The term undercutting is not defined in the Ordinance, ISAs and the ICAP Code of Ethics.

The dictionary meaning of undercutting is "to offer goods or services at a lower price or rate than (a competing price or rate) or than that of (a competitor)".

The Technical Advisory Committee of the Institute explained the term undercutting in its technical opinion issued in 2009 on '*Appointment of one auditor in place of two retiring auditors*', reproduced below as:

*"... Literal meaning of the verb 'undercut' means "to sell or work at lower price than". To Stretch the term, Undercutting may also mean to gain out of an event, transaction or appointment at the cost of another. Accordingly, if the incoming auditor takes up an audit appointment at lower fees to the detriment of the existing auditor whether directly or indirectly, it would amount to undercutting. To put it plainly, the Committee observed that charging a smaller fee in itself is not a conclusive proof of undercutting since there may be good reasons for it to prove otherwise. Undercutting is, therefore, always a question of fact dependent on the circumstances of each case".*

(underline is ours)

7. The above discussion highlights that the undercutting related provision of the Ordinance is applicable to the 'auditor'. Further, the ICAP Code of Ethics links undercutting to the audit engagements, only.

Reading together the above-mentioned provision of the Ordinance (paragraph 3 above) and requirements of the ICAP Code of Ethics (paragraph 5 above) transpires that the auditor's fee should not be lower than the last year's fee, for the:

- a) Statutory audit and related engagement(s) that can only be performed by a statutory auditor under the provisions of the applicable laws.
- b) Audit of financial statements of an entity performed by an auditor.

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8. The Committee, based on the above principled requirements and their application to the enquired fact pattern and also in consideration of responsibilities of statutory auditor, noted that:
  - a) Duties of the statutory auditor are established by the law applicable to the company e.g. the Companies Act. These duties would be same for any statutory auditor, whether acting as a single auditor or as a joint auditor.
  - b) In joint audits, two (or more) audit firms are appointed to share responsibility for a single audit engagement and to produce a single audit report. The auditors carrying out the audit collectively and signing the auditors' report jointly are called joint auditors. While, each audit firm would be referred to as a 'joint auditor'. In general, the audit fee is equally shared by the joint auditors.
  - c) In context of auditor's responsibility, every statutory auditor (whether appointed as a single auditor or as a joint auditor) is required to ensure that the audit is conducted in accordance with the ISAs and that sufficient appropriate audit evidence (including the work performed by the other joint auditor) has been obtained, which would enable the statutory auditor in expressing an audit opinion on the financial statements.
  - d) With regards to the joint audit, with the expression of an audit opinion on the financial statements a joint auditor is jointly and severally responsible for the audit with other joint auditor(s). Therefore, the joint auditor takes the responsibility for the entire audit (i.e. not only of his own work but also jointly responsible for the work of other joint auditor).
  - e) The quantum of audit work, in general, varies as a result of changes in underlying business/operations of the company or auditor's approach. Resultantly, the quantum of audit work could vary from one year to the next year. However, this aspect would involve evaluation of facts and circumstances in each case.
9. On the matter of audit fee and its relationship with the audit quality, the Committee considers it relevant to highlight that the Audit Quality Framework issued by the International Auditing and Assurance Standards Board outlines that there is usually a relationship between the quality of an audit and the quality and quantity of the resources used in its performance (as usually reflected in the audit fee).

While auditors have a primary responsibility for the quality of the audits they perform, other stakeholders have an equally important role to play in ensuring that financial considerations in relation to audit fees do not drive actions and decisions that impair audit quality. The Committee, accordingly, understands that company's management and those charged with governance have an important role to play in ensuring that financial considerations relating to audit fees do not compromise independence and audit quality.

### **Conclusion**

10. The Committee based on the:
  - a) information provided in the enquiry;
  - b) consideration and evaluation of the legal and ethical requirements related to undercutting (contained in the Ordinance and ICAP Code of Ethics); and
  - c) consideration and analysis of the duties and responsibilities of a statutory auditor outlined in the Companies Act and the ISAs

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concluded that the audit fee of a single auditor shall not be less than the audit fee of a joint auditor.

11. The Committee also concluded that in accordance with the provisions of the Ordinance and requirements of ICAP Code of Ethics, undercutting is prohibited for the:

- a) Statutory audit, review and related engagement(s) that can only be performed by a statutory auditor under the applicable laws; and
- b) audit of financial statements of an entity (such as audit of financial statements of provident fund of company, audit of financial statements of a project etc.)

*(Issued in August 2020)*