# <u>Role of auditors in Corporate Governance</u>

By

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## Introduction

Corporate governance refers to the mechanisms and processes by which corporations are governed. At the most elementary level, it can be described as the processes by which investors attempt to minimize the transaction costs and agency costs associated with doing business within a firm. Hence, the need for good *Corporate Governance* essentially arises due to the division between ownership and control which characterizes almost all modern companies. The primary trouble with such division, which forms the principal focus of corporate governance principles, is what is known as agency costs i.e. the tendency of the management, through its various instrumentalities, to sub serve the stake holder's benefits to other objects which affect these stakeholders detrimentally. Auditors are one such agency which allows the shareholders of a company to get an unbiased analysis of the finances of the company yet smooth day to day functioning of the auditors depend a lot on the cooperation by the management with whom the auditors interact more, as result many a times the management finds that auditors could be more pliable then the shareholders and commit fraud with the collusion of the very agency which was supposed to check and prevent such practices.

## Importance of Auditor in Corporate Governance

In the Indian context, the *Irani Committee* has suggested a four point agenda to be adhered to in the company's preparation of its account which is as follows:

- Disclosure accuracy and adequacy
- Standardization
- Clarity
- Synchronization of law and Accounting Standards

Auditors of the Company play an important role in all the aforementioned aspects of Governance primarily through its provisions from Section 224 to 233 of the Companies Act which seek to regulate the audit of company's accounts and its external auditors. As has been discussed hereinbefore auditors act as eyes and ears of the shareholders and prospective investors, thus to instill confidence in market and to provide a true and fair account of the company the role of an

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unbiased objective auditor is an undeniable necessity. Before proceeding to an analysis of the Indian provisions of law and the recommendation of various committees and recommendations in this regard, we would like to provide an account of two major corporate scandals which took advantage of poor accounting standards and disclosure requirements i.e. ENRON from the USA and Parmalat from Europe.

Enron Debacle

One perspective of analyzing the reasons for Enron Debacle is the role played by the auditors especially the old and prestigious firm of Arthur Andersen. Studies after the collapse of Enron have concluded that outside investors, including financial institutions, may have been misled about the corporation's net income (which was subsequently restated) and its losses and liabilities (which were far larger than reported). There was hence failure in the report to reflect clearly the inner picture of the corporation's finances. At the very outset however, it is emphasized that these *misrepresentations were made despite the fact that there were already mechanisms in place in the USA for the protection of investors and the public as a whole.* These safety measures included Generally Accepted Accounting Principles (GAAP), Generally Accepted Auditing Standards (GAAS), Statements on Auditing Standards (SAS), and all professional ethics. Enron took these rules and circumvented them to allow certain individuals within the company to make money from the increased investments from stockholders. They did this by bolstering their balance sheet with inflated asset values, and dispersing their liabilities to subsidiaries that they just didn't consolidate. This was made possible in part, by certain actions of the leading partner on the audit, David B. Duncans, who went to great lengths to conceal and overturn internal memos which highlighted conflicts between the internal auditors and audit committee of ENRON.

One of the most important causes for this audit failure was the fact that the independence of Andersen had been compromised on account of the close personal and financial interests of the partners in ENRON and because of the huge fees which Andersen received for its non-audit services. Both these factors compromised the independence and objectivity of the audit firm. *Hence the ENRON scandal clearly shows that the mere existence of accounting standards will not suffice in the absence of independently functioning external auditors and moreover an*

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*understanding by the Company itself that self-compliance to assigned corporate government standards benefits them.*

The Parmalat Scandal

Parmalat, a corporate debacle comparable in size and intricacy to its major U.S. rivals, and thus quickly dubbed 'Europe's Enron'. Food giant Parmalat, Italy's eighth-largest industrial empire, collapsed amid fraud accusations against top company executives and scandal involving several major players from the world of international finance. In contrast to Enron where the manager's pushed accounting regulations to the limits, Parmalat also employed more traditional means to falsify its records i.e. blatant forgery paying no heed to the law and painting a picture of an imaginary company for the eyes of the public. Parmalat thus took Enron's fraud to the next level; instead of distorting its accounts, it simply forged a set of completely different ones.

The similarity with Enron is that the management was amply aided by the external auditors. Parmalat executives, have testified that the lead partner on the Parmalat audit were aware of the true financial status of the company and repeatedly helped Parmalat's management set up its fraudulent schemes. i.e. in both the gatekeeper's failed. Hence it becomes clear that the *Parmalat situation was one where there was effectively no law due to poor enforcement systems allowing blatant forgeries coupled with a lack of voluntary compliance with financial disclosure and transparency principles of corporate governance.*

The Indian lesson on auditing fraud

India sought to learn from both *Enron* and *Parmalat*, as a result over the last few years there has been a flurry of recommendations and enacted self regulations, the pace of which increased after the Indian IT giant Satyam entered the hall of infamy with the biggest auditing fraud in Indian corporate history. The primary duties of statutory auditors have been listed in Section 227 of the Act. The basic thread running through the powers given to the auditors and the consequent duties imposed on them is that the audit of the company should be carried on in such a way that the auditor is in a position to certify that so far as the balance sheet and profit and loss account of the

company is concerned, it gives a *true and fair view*[1] of the company's financial affairs.[2] In reaching this opinion, the duties of the auditor broadly involve conducting enquiries[3], reporting on the basis of such enquiries to the members on the compliance of the propriety and adequacy of accounting standards[4] adopted in the books of account, profit and loss statement and balance sheet. The concept of Audit Committees was introduced in India by the Companies (Amendment) Act, 2000.[5] The Audit Committee is a committee of directors (mainly non-executive) whose primary responsibility is to review the financial statement before their submission to the board.[6] Section 292A requires that both the *internal auditor and the statutory auditor* attend every meeting of the Audit Committee but shall not have the right to vote. The primary function of the internal auditors in the audit committee is to appraise the Committee which mainly consists of the non-executive directors of the company, with a review of the organization's power and control structures, an objective evaluation of the existing risk and the internal control framework, a systematic analysis of business processes, reviews of the existence and value of assets, reviews of operational and financial performance etc.[7] It has however been argued that since the terms of reference of the Audit Committees are to be articulated by the Board of Directors themselves, these Committees will be effective *only in a situation of voluntary compliance*.[8] Hence, once again the speaker would like to assert that mere existence of a legal framework aiding corporate governance measures will not suffice and the adherence to these rules in spirit must come from *within the company itself*.

Hence it can be seen that the law accords tremendous significance to the duty of the auditor in providing to the shareholders and accurate and fair understanding of the affairs of the company. It is clear that the auditors are the fiduciaries of the shareholders and not of the management.

Proposed reforms

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[1] *See* Section 209 (3) of the Companies Act, 1956 which provides that for "books of account to be proper" they must give a true and fair view of the state of affairs of the Company

[2] *See* A. Ramaiya, *Guide to the Companies Act*, Wadhwa & Co.,16th Edn., (2004) p. 2373

[3] *See* Companies Act, 1956, Section 227 (1A)

[4] *See* Companies Act, 1956, Section 211 (c)

[5] *See* Companies Act, 1956, Section 292A

[6] *See generally* S.K. Tuteja, *Empowering Audit Committees In India*, [2004] 54 SCL 38 (Mag.)

[7] *See* KPMG, *Internal Audit's Role in Modern Corporate Governance*, obtained from http://kpmg.com.sg/publications/ras_IntAuditsRole.pdf, last visited 4th Dec 2006

[8] *See* Pawan Agarwal, *Audit Committees – Success will depend on voluntary compliance* , [2003] 42 SCL 108

The term ‘Independent auditor’ (unlike that of independent director[9]) has not been defined in the relevant Indian statutes. Instead, the Act has taken a route wherein it seeks to restrict and monitor the manner of functioning of the auditors and maintain objectivity in their appointment process thereby ensuring independence.[10]

The independent functioning of the auditors of a company as an aspect of corporate governance generally brings up the following issues. It hence becomes important to analyze these aspects and the reports and amendments seeking to address them.

- **Engagement in Non-audit services**

Studies in Australia and U.S.A have shown that a high purchase or engagement of an auditor in non-audit services affects independence and the nature of opinion of the auditor.[11] *This aspect of separation between audit and non-audit functions* was first taken by the Security Exchange Commission of the USA[12] and now has found acceptance even in India by the ICAI which has set up a working group in this regard.[13] This also came under the scrutiny of the Naresh Chandra Committee Report [*Hereinafter* NCCR] which recommended a list of prohibited non-audit services[14] which is very similar to that under Section 201 of the SOX Act. At present, the Act does not have any provision prohibiting the rendering of non-audit services by a statutory auditor to the client, but this situation cannot last long keeping in mind the central role played this particular aspect in the ENRON controversy.

It can be seen that the Companies Amendment Bill 2003[15] proposes the introduction of new section 226A which incorporates the NCCR’s recommendations *verbatim*. However, the proposed Section 226A(j) adds to the list “*any other service that may be prescribed*” This is modeled on the lines of S. 201 of the SOX Act which allows Public Company Accounting Oversight Board set up under the auspices of the Act to identify other services. The NCC was

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[9] *See* Clause 49 of the SEBI Listing Agreements
[10] *See* P.T. Giridharan, *New Prescriptions for the Independent Auditor*, (2003) 4 Comp LJ 113 (Jour)
[11] *See* G.F. Mehta & Asif Iqbal, *Auditor’s Role in Good Corporate Governance*, (2004) 4 Comp LJ 54 (Jour); *See also* The Panel on Audit Effectiveness: Report and Recommendations (the "O'Malley Panel Report" available at http://www.pobauditpanel.org/download.html, last visited 4th Dec 2006;
[12] *See* Securities And Exchange Commission, Final Rule: Revision of the Commission’s Auditor Independence Requirements (effective date Feb 5th 2001), obtained from http://www.sec.gov/rules/final/33-7919.htm
[13] *Supra note* 11
[14] *See* Naresh Chandra Committee Report, Para 2.10
[15] *See* The Companies (Amendment) Bill, 2003 available at http://dca.nic.in/comp_amendbill_2k3html.htm, last visited on 4th Aug 2009

well aware of this provision and did not incorporate this in their suggestion deliberately because they did not recommend the setting up of a body akin to that under SOX and felt that the restricted listed prohibitions would suffice in maintaining auditor independence. This is made abundantly clear in the following statement in the report *"Most of these prohibitions already exist in India….Even so, the Committee believes that it is necessary to provide an explicit list of prohibited non-audit services."* In the absence of a specialized body like that under the SOX in the Indian context to deal with this, such an important power must not be delegated as this would result in over-regulation.

- **Appointment, Remuneration, Disqualification of Auditors**

Section 226 of the Act talks about the qualifications and disqualifications of auditors and Section 224 speaks about their appointment and remuneration. As regards appointment, the Act provides that every company shall, at each annual general meeting, appoint an auditor or auditors to hold office from the conclusion of that meeting until the conclusion of the next annual general meeting. This provision has not come under slack form any corner and has been recommended to continue by both the Irani Committee[16] and the NCCR. The NCCR however stated that *"the primary point of reference for the appointment, terms of reference and fees of the auditing firm must be the Audit Committee of the board of directors. The second level of decision-making should rest with the full board, subject to a positive recommendation by the Audit Committee. And the final approval must rest with the shareholders at the company's AGM"*[17] The good sense behind this recommendation is clear in so far the audit committee certainly has that degree of independence and objectivity as compared to the Board and this finally translates into a good set of candidates for the shareholders at AGM from which they can choose.

The NCCR also recommends the introduction of some new disqualifications for the appointment of audit firms on the basis of the financial, business or personal relationships of the partners with the firms and the same have been incorporated in the Bill.[18] These are more or less

[16] *See* Irani Committee Report, Para 22

[17] *Supra note.* 14, Para 2.26

[18] *See generally* B.J. Shah, *Provisions Relating To Auditors: An Examination of the Amendments Proposed in the Companies (Amendment) Bill 2003*, [2003] 47 SCL 105 (Mag.) for criticisms of some of these provisions.

straightforward and seek to minimize the five different kinds of bias which an auditor may have as identified by International Federation of Accountants.[19]

As regards the remuneration of auditors, Section 224(8) provides that it shall be fixed by the shareholders as per the decision of the shareholders in the AGM. The Irani Committee recommended non-inclusion of reimbursement from the basic remuneration which it called as an *'audit fee'*. The speaker feels that this should be accepted particularly in light of the observation by the NRC wherein it states that audit fees in India were generally quite low and this might, over time, impinge upon the quality of audit.[20] This would at least result in a marginally higher fee being paid to the auditor's as remuneration. It must further be kept in mind that if the provisions regarding prohibition of rendering of non-audit services are enacted, a major source of the revenue for the auditor's is cut off. In fact, the speaker hopes that active consideration is given to the introduction of a minimum audit fee despite the NRC explicitly saying that the measure would not be prudent at present. Give the fact that the auditors owe a fiduciary duty towards the company on misrepresentation by the auditors, provisions for civil and criminal proceedings against such breach of fiduciary duties should be provided by the suitable amendments in IPC and relevant civil codes.

- **Change in service conditions**

Presently there is no limit for any time period till when an auditor can be retained, i.e. the same auditors can be retained year after year. The protection to the interest of shareholders in this system is dependent of the consent in the AGM, however in the Indian system where most of the shareholders abstain from AGM there is little chance of supervising the appointment of auditors. Also familiarity with same set of auditors would lead to greater chances of manipulation, thus there should be a provision of mandatory change in auditors every 2 years. This would make the management stand on its toes and would ensure that there is little or no chance of collusion between the management and the auditors to defraud the shareholders.

- **Standard of care and skill**

[19] *See* IFAC, Code of Ethics for Professional Accountants (Section 8 — Independence), pp.7-8
[20] *Supra note.* 14 P*ara* 2.25

The law says that the auditors must exercise *reasonable* care and skill, however the standard of reasonableness has never been mentioned legislatively. The only interpretation that we have is given judicially in the *City Equitable*[21] case where Romer J, clarified that '*reasonable care* in any particular case would depend upon the circumstances of that case', this stand was judicially incorporated in India in *Ganeshan v Joscelyne*[22] where the Calcutta HC used a similar standard to judge whether auditor has committed negligence/dereliction of duty. However if we look at the standard of care test for medical professionals we have the famous *Bolam test*[23] which impinges upon doctors to exercise "*the ordinary skill of an ordinary competent man exercising that particular art*." A comparative analysis of the standard of care would lead us to the conclusion that the standard for doctor is much higher compared to auditors, one may argue that given the fact that doctors handle with life a higher standard is expected but so it is important to understand the immense liability and responsibility on auditors and to imbibe that duty of auditors is in no way inferior if not superior to duty of any other professionals. Thus there is an urgent need to buttress the law by laying down what we mean by reasonable standard and skill.

- **Adding a gatekeeper or supervising him**

Auditors are gatekeepers to the finances of a company, they give the exact, untainted financial picture of the company to the public. But given out experiences some auditor or other in future would collude with the management and commit fraud. To stop this we may add another level of security, some suggest that there may be a sample audit over the audited report, however some others propose that such a dual audit even in smaller scale would be costly and they propose that a company may include shareholders to assist/inspect the work of the auditors. We believe that the second approach would insure greater accountability of the auditors and would also lead to diminishing chances of collusion between management and auditors.

Conclusion

We are hopeful that if the recommendations as proposed by us are implemented then transparency is bound to increase and would have a domino effect on corporate governance, thus by governing the auditors we may insure that corporate governance as a whole receive a fillip.

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[21] [1925] Ch 407, 481-482: [1924] All ER 485

[22] AIR 1957 Cal 33

[23] 1957) 1 WLR 582