

THE EVER EVOLVING ROLE OF AN AUDITOR THROUGH THE PRISM OF CORPORATE GOVERNANCE

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Abstract

An auditor is a third party entity; their major role is to achieve balance between taking care of interest of stakeholders and company management. Considering many frauds and failures in the accounting functions and systems, the roles and responsibility of corporate governance and has increased in last few years. It is therefore imperative that a fresh look is cast at the functions, authorities and responsibilities of external auditor as mentioned in the corporate governance policies. This paper focuses on the new perspective of role of auditor in corporate governance and accounting system. Many scams and frauds provide an insight to reevaluates the roles of auditor in corporate governance system. Further this paper tries to understand various legal responsibilities of auditor in the latest corporate governance system and ever changing business environment. It has been evident that position of auditor is quite questionable in the Indian accounting system. So, this paper evaluates ever dynamic function of auditor.

Key Words: external auditors, corporate governance, independence, framework,

STUDY OF ROLE OF AUDITOR WITH REFERENCE TO CORPORATE GOVERNANCE NORMS IN INDIAN ORGANIZATIONS

INTRODUCTION

Modern corporates are the major drivers of the economy in any country. The relationship between company management and stakeholders, engendering the third party entity problem summarise the corporate governance policy of the organisation. The providers of various capitals assure themselves of getting a return on investment through corporate governance mechanism (Shleifer and Vishny, 1997). Effective corporate governance aligns the interest of the company management with that of the shareholders', thereby, reducing the agency cost. The two independent watchdogs, instigated to unravel the given problem are "Independent Directors" and "External Auditors".

The external auditors, by doing their duty of verification task as very significant supervising agency that keeps an eye on company management. This makes them, a vital constituent of corporate governance mosaic (Cohen et. al., 2002).

In the past twenty years, vary fast and wide varieties of changes in corporate governance has strengthen the position of the auditor's position as a regulator. The perceptual accounting and auditing letdown like Enron, WorldCom, Paramalt, and recently Satyam has revealed the severe loopholes in auditing. India's largest accounting fraud "Satyam" has dented auditing profession (Satyan, 2009) and level out the obvious conflicting position of auditors in the Indian business environment. Therefore, it is an appropriate time to reassess the auditor's job in the regulatory framework. Next section of the paper discusses the external auditor's statutory and governance role in the contemporary environment. Subsequent parts reveal the questionable role of auditors. Hence the position of auditor and auditing in India is very significant. - Particularly pertaining to enhancing the auditor's independence and lastly with concluding remarks on role of the auditors in the Indian corporate governance.

AUDITING/ AUDITORS AND CORPORATE GOVERNANCE

Statutory Role Auditors

According to the International Federation of Accountants (IFAC), one of the major goals of an audit is to help the auditor to provide a view on the financial statement is made in all relevant respects, and according to the specified financial reporting mechanism (IFAC, 2010). The auditor's opinion helps to determine the true and fair financial situation and performance in terms of results of an enterprise. This is taken as most customary position of the auditors, and permission so by the corporate legal framework of major parts of the world (Porter et. al., 2005; Jayalakshmy et al. 2005; Baker & Owsen, 2002). In India also, the auditor is cast with the responsibility of ensuring this aspect. Provisions relating thereto are contained in Section 211 and Section 227 of the Indian Companies Act, 1956 (herein Companies Act).

According to Section 227(2): "the auditors will prepare a report to the members of the organisation on the accounts evaluated and checked by him ... and the report shall mention whether, in his view... the said

accounts provides the information needed by this Act in the manner so required and give a true and fair view...."

As it is already mentioned that the auditor's legal role pertains to finding and presenting truth in financial reporting, an auditor plays the key role in protecting interest of various stakeholders including shareholders. Auditors based on their observation and judgment assess the true economic value of an enterprise.

AUDITOR'S GOVERNANCE ROLE IN CURRENT FRAMEWORK

With development of corporate governance codes and new statutes, the auditor's role has implicitly enhanced to a great extent, than only from the traditional role of assessing the true and fair value of a corporation., Cohen et al. (2002) are of the view that the external auditors are an integral part of the corporate governance, and they are entrusted to adopt better practices for further improving it.

Usefulness of auditors in corporate statutory system have been very much emphasized, as they are very important protection mechanism against any kind of exploitation because of their role of justifying and checking company's financial statements. Still the auditor's role believes that more importance is given to the very challenging role of auditor in external and internal business structure. The auditor is needed to perform key role in vouchsafing the system, in both financial management and other allied areas (Chakraborty, 2004).

Fraud and error in financial statements

The auditor is majorly responsible to provide his views on financial accounts regarding its fairness and reliability. This stems from the fact that as far as auditing functions is complete responsibility of auditor more than legal role of him. Auditor is liable to protect from any scams or malfunctions in financial statements of organisation. In fact, these were the early views on auditing, and the audit was intended towards physical verification of the accounts to detect and prevent fraudulent activity (Watts & Zimmerman, 1983; Mills 1990; Chandler, 1993; Porter et al., 2005). Varottil (2009) comments on the Satyam fraud that "there was a clear failure of audit process as the genesis of the fraud can be pointed to the misstatement of financial information". The auditor has obligation to design procedures, which will enable him to obtain evidence to have reliable assurance that the financial statement is stated in all material aspect

Financial Reporting and Decision Making

External audit is a crucial monitoring device in the financial reporting process. It is very significant corporate governance system, which lower down the information asymmetry and publicize very trustworthy information to stakeholders of the organisation. (Chakraborty, 2004; Ashbaugh and Warfield, 2003). There is a very strong and positive association between the value of corporate governance and the integrity of financial reporting (Cohen et al., 2004). Different people and agencies now frequently utilize and rely upon the audited financial statement for taking their financial decisions, particularly as a pointer of the current financial position and future earning capacity of the company (FASB, 1978). High-quality financial audit significantly reduces the risk that investors and creditors face with their investment decisions. However, the investors decision assume significance in future if they provide evidence to them due to some material misstatement in the evaluated financial reports and accounting statements not evaluated by auditor (Chakraborty, 2004). Internal control and Risk Assessment: In dynamic business environment, the external evaluator cum auditor can play very important role in helping the management to prepare appropriate risk management and internal control system in the company (Gwilliam, 2003; Holm and Laursen, 2007).

Internal control is very important and integrated part of auditing norms across the world as far as the risk management functions is concerned. In Indian, the issue of internal control of a company is taken care by provisions of the

Processing and other organisations order 1988, as per this legal provision, the outside auditor is required to state in their report if the organisation has taken proper internal control mechanism that is compatible with the size and scale of organisation's business. Auditor can help corporate management to establish suitable control system and risk management in diverse operational areas so that the Board of the company can focus on appropriate areas and develop strategies for the same. Appropriate internal control system assumes significance for proper utilization of resources and guard against fraud & errors (Chakraborty, 2004, Porter et.al., 2005).

Potential financial viability of Organisation

The auditor carries very crucial responsibility of evaluating the company's potential ability to earn and its sustainability to perform business in coming time period. According to the auditing provisions prevailing across the world (ISA 570, IFAC; AAS 16 India). The auditor is required to keep an eye and follows the going concern principles which provide report about potential financial sustainability of the business. The auditor is responsible to approve qualification or disqualification report for the organisation. This kind of report is very critical and important for taking right decisions in the interest of stakeholders and future investors of the

organisaition. As per provisions of section 227 (3) (e) of the Companies Act, the report provided by auditor is considered to be very apt observation to avoid adverse future situation of company.

Conformity with Provisions and Legal rules

SEBI has laid down legal auditors of the organisation in conforming to the clause of 49 of agreement that is in complete support of provisions of corporate governance for the listed organisations in India. The auditor is required to provide certificate to the organisation about compliance of legal provisions and rules. The auditor is also required to certify the annual and director's report. " The objective of SEBI shows that the trust on auditor provide faith in financial statement of the organisaition and corporate governance mechanism to provide protection of the stakeholder's interests.

The outside auditor provides their view on compliance of the accounts and statements of financial nature of the organisations as per clause 49 of Indian Accounting Standards. The auditor has very critical role of verifying the qualification or disqualification of director. As per section of 227 (3) (f), the auditor is also required to provide report if any appointed director fulfills the eligibility criteria.

Other Legal Role

According to the corporate governance mechanism there is negative association between auditing committee and the auditor is very significant for providing financial sustainability of the organisation. Auditor is required to fulfill specific responsibility of communication of any audit related matters in the interest of organisation and stake holders to the audit committee and the Board (AAS 27, India). The pervasive feature of Indian companies is high ownership concentration, further marked with pyramiding and tunneling (Chakrabarti et. al., 2008). Therefore, related party transactions are very common and assume great significance in such context. The regulation requires companies to reveal their transactions of the party; the auditor is required to find out, assess and inform about related transactions in the report. These kinds of disclosures increase the clarity in the financial statement of the organisation.

Position of the auditors in latest Indian legal system, Indian legal framework has very large number of provisions that an external auditor is required to follow. So, it is very obvious that auditor carries very critical roles and responsibilities in the organisation.

Still many innate problems and loopholes in Indian auditing are prevailing. Such lacunas are responsible for many scams and frauds revealed in Indian economy.

According to the World Bank report published in 2004, standards and benchmarks in Indian corporate governance and legal system needs through change and some principles needs to get change. The report suggest that instead of accounting standards related to financial statement is very much observed, still the efforts are required to increase auditor's autonomy of actions and taking independent decisions. This report further suggest that India has high amount of legal compliance with international standards have to disclose any deviation from normally accepted accounting practices (Clause 49).

Another report from Standards and Poor's (2009) has observation that financial disclosure practices of the Indian companies are generally better than the other Asian Countries. Standard and Poor's (2009) report, also commends the adoption related party standard (AAS 18) as a vital one in improving the corporate transparency, particularly group affiliates. However, non compliance with the financial disclosures has been quite common by the companies, as penalties level are low, no prompt action on part of SEBI and hardly any case of imprisonment as per law (World Bank, 2004; Standard and Poor's, 2009). The auditor's non deterrence in following the rules and regulations as per law is common due to very minimal provisions of financial penalties and also supported by judicial delays that is snatching the real role of auditor in corporate governance (World Bank report, 2004; Standard and Poor's, 2009).

According to World Bank report published in 2004 has stated that the type of disciplinary steps against the auditors is very important and key to reduce the scams and frauds in the system. Such scams and frauds reduce the trust and interest of stake holders in the organisation. Most importantly the small investors must be satisfied by removing such legal steps and disciplinary actions.

The report (World Bank, 2004) makes counsels for adoption of the Naresh Chandra Committee report to Increase the quality of audit by accepting and evaluating enforcement techniques in line with US. The report reveals various aspects of the auditor independence - non-audit services to client, rotation of auditor & qualified audit reports, and suggests adopting them through suitable legislation. Some recommendations of the Committee are considered in the Clause 49 that manages the independence of auditing process; however, much more needs to be done.

PROPOSED REFORMS

The reforms proposed are aimed at maintaining an opposite relationship between company and auditors, which can augment the auditor's role in corporate governance. The main effort is to enhance the audit quality, which is substantially dependent on auditor independence. Therefore, an elaborate discussion on auditor's

independence is pursued. But first we need to look upon the recommendation of the Naresh Chandra Committee on Corporate Audit and Governance (Chandra report, 2003) and reforms proposed under new statutory framework of Companies Bill, 2009 (herein 2009 Bill).

Naresh Chandra Committee Recommendations on Audit

The Naresh Chandra Committee recommendations were much influenced by the Sarbanes Oxley (herein SOX) Act of the United States. Committee after much deliberation made significant recommendations for modification in the Companies Act, which was proposed through Companies Amendment Bill 2003. The recommendations were related to audit (recommendation 2):

The statutory auditor - company relationship to further strengthen the professional nature of this interface;

The need, if any, for rotation of statutory audit firms or partners;

The procedure for appointment of auditors and determination of audit fees;

Restriction, if necessary for non-audit fees;

Independence of audit findings;

Measures required to ensure that management and companies actually present "true and fair" statements of the financial affairs of the companies;

The need to consider measures such as certification of accounts and financial statements by management and directors;

The necessity of having a transparent system of random scrutiny of audited accounts Adequacy of regulation of chartered accountants, company secretaries and other similar statutory oversight functionaries;

Advantages, if any, of setting up an independent regulator similar to Public accounting Oversight Board in the SOX Act of United States, and if so, its constitution.

Companies Bill 2009

The recommendations of the Chandra committee, though if implemented would have boasted the role of auditing/ auditor in corporate governance, but, they never found their way into the statute books (Sucheta Dalal, 2003). In the current regulatory framework proposed by Ministry of Company Affairs (MCA) in Companies Bill 2009, many of the recommendations of Chandra committee have been incorporated.

- (a) The Bill establishes the National advisory Committee on Accounting and Auditing Standards. The advisory committee is entrusted with role of advocating the Government of India on the formulation of accounting Standards, after the consultation with ICAI.
- (b) Creditors, debtors, shareholders, guarantors or those business relationships with company, or their relatives or partners cannot be appointed as auditors. The approval of seventy-five of shareholders of the company is required to remove an auditor before the completion of his term.
- (c) Auditors cannot provide certain services to companies they audit. These include accounting and book keeping services, internal audit, and management services.

AUDITOR INDEPENDENCE

Auditor independence from the client's perspective is considered as one of the prerequisites for a good-quality audit. As already discussed, most of Indian companies are promoter controlled and in such case, an auditor may lose his independence in fulfilling the statutory and other governance duties. Auditor's independence in such situation assumes great importance and become imperative for enhancing the auditor's role in Indian corporate governance framework. The present discussion looks upon the factors and reforms undertaken that possibly impair the auditor independence.

Provisions for Auditor's Disqualification

Auditor's separate legal existence and independence is mentioned in Companies Act section 226. Many other reports like Chandra Committee has said that there is dire need of more and rational norms for qualification or disqualification of appointment of auditor. Such suggestion of the committee was considered in companies act amendments took place in 2003, yet it's not fully practiced in Indian corporate. Further it was again considered in the amendment took place in 2009 in companies act clause 124. According to which an auditor can be disqualified based on his personal and business association with the company.

Auditor's Appointment

According to section 224 for companies Act, an auditor's appointment in every organisation is announced in Annual General Meeting held every year. Generally an auditor is required to perform his duty till the next Annual General Meeting of the organisation. So, it can be said that minimum tenure of the auditor is of one year in general. Many policy makers have not favored this system of appointment of auditor. Report of Chandra committee said that ultimately the decision for appointment of auditor is to be taken by audit committee. Firstly the audit committee will decide about appointment and then it will be present to BOD and Shareholders of the company.

Services Related to Non Audit Function

Many corporate fiascos like Enron in America or Satyam in India have exposed the involvement of auditor in the non-audit related functions. Such involvement of auditor in the non-audit related functions affects the independence of auditor in the organisation. Even such engagement in non-audit function also raises many questions on reliability and trustworthiness of the financial statement audited by auditor. Certain committee report such as Chandra committee has mentioned various non-audit functions, wherein auditor of the organisation should not be involved. The same list of non-audit activities were further mentioned in companies act amendments took place in 2003 and 2009.

Regular Change of Auditor

Although the regular replacement or change of auditor is not mentioned in any legal framework in India, it is always advisable to rotate the auditing firm on regular intervals. There are instances that single auditor keeps on working with same organisation for many years. Such long term association between auditor and the organisation result into strong relationship which ultimately leads to affect the independent entity of the auditor. Even the acts in USA as well as Chandra Committee strongly suggest the regular change of auditor in the organisation at every regular interval. This matter of regular rotation of auditor has not mentioned in any amendments of companies act. After satyam fiasco, SEBI has suggested such change in auditor after regular intervals.

Provisions Regarding Audit Committee

According to the companies act section 292, there should be an independent audit committee formed in the organisation. Clause 49 of section 292 of companies act suggest that there should not be any direct or indirect control of management body of company over auditor of the organisation. There must be an audit committee formed in the organisation, this committee is responsible to look after audit functions and compliance level in the organisation. Major areas that are taken care by audit committee include appointment of Auditor, Remuneration of Auditor, and Removal of Auditor etc. Companies act also suggest that audit committee is also responsible to overcome conflicts take place with the auditor of the organisation. The major role of audit committee is to ensure independent status of Auditor in the organisation.

Auditor's Remuneration

It is generally observed that higher payments made to auditor in terms of fees adversely affects the independence of the auditors. There are many examples that reveal this situations. It is seen that over payment to auditors in terms of fees leads to loss of independence of auditor. According to Companies act, remuneration of or fees of the auditor is decided by audit committee. Many committee reports also suggest that when auditors are not allowed to do non-audit related functions their fees will be reduced. It is suggested that there must be provisions regarding minimum and maximum audit fees in companies Act.

Independent Board

Institute of Chartered Accountants of India (ICAI), has recently stated that there must be some other board to take care of entire audit process performed by auditor of the organisation. It is suggested that, an independent board should be set up to evaluate the audit functions of the organisation. Formation of such independent third party board with enhance the reliability of the audited financial statements as well as the autonomy of the auditor in the organisation

CONCLUSION

External auditors are the very old and famous agency, to ensure protection of the interest of the stake holders by evaluating and checking the financial statements and give their views on it. In past ten years, Indian Financial Market have grown very rapidly, easy reach of market has been given to foreign nationals, investors, numerous corporate frauds, happened, and vast developments in the field of corporate governance have taken place. All these enhance auditor's accountability in the organisation, and make them very important part of corporate governance system. They are now professed to play different roles and responsibilities, other than their statutory responsibilities in this contemporary business environment.

This paper has reveals the auditor's position in Indian corporate legal system. Most of the companies in India have general feature of high ownership concentration of promoter with their direct or indirect control on the management. All this weakens the auditor autonomy to operate and their effectiveness in the audit function. The recent reforms in corporate governance proposed by SEBI in the form of Clause 49 has improved the status of auditing and given much needed importance to responsibility of auditors. However, much more has to be done in order to improve the status of auditors, particularly for enhancing the auditor independence. It also becomes necessary to understand from the Satyam fiasco, the factors that impair auditor independence. The reforms proposed by the Chandra committee and in the proposed Companies Bill, 2009 are in the right

direction. The regulators and legislators have an excellent opportunity to strengthen the position of auditors in the proposed framework so that they may play an effective role in the corporate governance.

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