ISSN 2278 – 0211 (Online)

Independence Auditor in India

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Abstract:
This article reviews the regulations and governance reforms carried out in India with respect to independence audit in India. In doing so it critically compares them with the regulations existing in the US. This is followed by a discussion of the existing research on the effectiveness of audit committees and audit independence in corporate governance. Recent trends in audit committee and auditor characteristics for a sample of large listed companies in the Indian corporate sector are then discussed. The article concludes by suggesting some governance reforms that may be considered to further strengthen auditor independence and the functioning of audit committees in India.

***Key words**: India, Audit, Committees and independent*

1. Introduction

The Enron debacle in the US, which led to the Sarbanes-Oxley Act of 2002 in the US, inuenced far reaching changes in regulations governing auditor independence and audit committee across the world. In India, the economic reforms which began in 1991 have put great emphasis on the role of the external auditor and the audit committee. The \Clause 49" regulations which were made part of the Listing Agreement by the Securities Exchange Board of India (SEBI) in 2001 required every listed company to have an audit committee and specified its composition, role, and power in detail. The Naresh Chandra Committee that was constituted in August 2002 produced an exhaustive report on the auditor-company relationship and the functioning of the audit committee. Many of these recommendations have been incorporated in the Companies Bill, 2009 which is currently waiting for legislative approval.

Theory and the empirical literature overwhelmingly suggest that auditor and audit committee independence plays an important role in the governance of companies. The recommendations of the NCC have set standards which are lined with international best practices. The Companies Bill, 2009 has incorporated many of these recommendations. For investors to have confidence in the independence of the auditor, the Companies Bill, 2009 needs to be enacted quickly into law. At the same time, there are many areas for improvement in the Companies Bill of 2009. The paper reviews the regulations and the suggested governance reforms in India with respect to auditor and audit committee independence.

On the issue of auditor independence, the paper discusses three key aspects which regulations try to address, namely (a) disqualification for audit assignments that arise due to potential conflicts of interest from employment, financial interest, and other relationships between the auditing firm and the audit client, (b) types of non-audit services rendered by the auditing firm, and (c) audit partner rotation.

On the issue of disqualification for audit assignments the NCC recommended that an audit firm will be disqualified from being appointed as the statutory external auditor if the audit firm, its partners or members of the engagement team as well as their `direct relatives' had any (i) financial interest in the audit client, (ii) received any loans and guarantees from the audit client (iii) had any business relationship with the audit client and (iv) had any personal relationships with the key officers of the audit client. In addition, the NCC also recommended (v) a cooling period of two years before any partner or member of the auditing firm can join the audit client, or any key officer of the audit client can join the auditing firm, and (vi) prohibition on undue dependence on an audit client in terms of audit fees.

The Companies Bill, 2009 incorporated the first four recommendations of the NCC report, but the recommendations regarding undue dependence and, more strikingly, the recommendation regarding the cooling period were not incorporated in the Companies Bill, 2009. The latter recommendation comes from the basic concern that a member of the audit engagement team who has only recently been a key officer of the audit client poses significant \self-review" threat as these persons will be less inclined to detect errors that they themselves may have committed in their capacity of a key officer of the audit client. Simultaneously, a key officer of the audit client who has only recently been a member of the auditing firm can significantly influence the auditors incentive, ability, and inclination to detect potential accounting and financial errors by the audit client.

With respect to prohibited non-audit services the NCC recommended nine types of services that an audit firm was prohibited from rendering to its audit client. The list of services mimic the list of services prohibited by the SEC except for legal services and expert services which are prohibited by the SEC but not recommended by the NCC. The Companies Bill, 2009 incorporated the first seven recommendations of the NCC but did not include the recommendations relating to (i) any form of staff recruitment, and particularly hiring of senior management staff for the audit client and (ii) valuation services and fairness opinion in the list of prohibited services.

On the issue of compulsory audit partner rotation the NCC recommended that all partners and at least half of the audit engagement team (excluding article clerks) be rotated after five years. The recommendation also provided for a cooling period of five years before rotated members can join the audit engagement team for the particular audit client. The NCC recommendations regarding auditor rotation are very similar to those specified under SOX regulations, but these have not been adopted in the Companies Bill, 2009. The Companies Bill, 2009 broke up the investment adviser or investment banking services separately into investment adviser services and investment banking services. Mandatory rotation exists for government firms but not for private listed companies.

The paper also looks at the size, composition, independence, and powers and functions of the audit committee, which plays a vital role ensuring the independence of the audit process. In doing so it makes a comparative assessment of such regulations in other countries.

While a significant number of proactive regulations have been enacted in India since the 1990s, there are two aspects which require further attention the composition of the audit committee and its authority to implement its decisions. A review of the sequence of regulations shows that there has been a steady dilution of the independence requirement with respect to the audit committee. The original Clause 49 regulations required the audit committee to have a minimum size of three and to be constituted entirely of non-executive directors with majority of them being independent.

The revised Clause 497 removed the non-executive director requirement and instead specified that the audit committee have a minimum of three members with two-thirds of them being independent. The Companies Bill, 2009 follows the revised Clause 49 regulations by not insisting that the audit committee comprise only of non executive directors but reverts to the majority rule rather than having a two-thirds rule. Given the minimum size of three a reversion to the one-thirds rule as opposed to the majority rule does not impose any extra constraint. The NCC in its report, while applauding the existing Clause 49 regulations on the audit committee, pointed out that one area that needed improvement and tightening was the composition of the audit committee and recommended that if the audit committee is perceived to be independent, then it should consist only of independent directors. Unfortunately this has not been incorporated in the Companies Bill, 2009.

The weaker independence requirement regarding the composition of the audit committee has to be seen in context of the fact that the audit committees recommendations relating to hiring, oversight, compensation, and firing of the outside auditor are not binding on the Board, in contrast to the regulation in the US where under the SOX Act of 2002, the audit committee is \directly responsible for the appointment, compensation, retention and oversight" of the statutory auditor and each such statutory auditor \must report directly to the audit committee.

After the Companies Bill, 2009 is enacted as law, two areas of work pending with policy makers are: the issue of independence of the audit committee both in terms of its composition and the power of the Board to overrule its decisions, and the issue related to conflict-of-interest in auditor-company relationship and audit partner rotation. These issues have to be addressed in future regulation to make auditing and oversight standards in India comparable to those in the more mature economies. If it is operationally difficult to obtain amendments of law in the near future, then SEBI and the Stock Exchanges need to explore the possibility of incorporating these additional standards of independence in the Listing Agreement. Since the provisions of the Companies Bill, 2009 can be interpreted as only laying down minimum standards; nothing prevents stock exchanges from insisting on higher standards of independence from companies listed under their supervision.

2. Auditor Independence

Auditors are the lead actors in the auditing process and provide independent oversight to the financial reporting by companies. Modern day corporations are huge and their operations are complex. While accounting standards and norms are specified by the regulators for proper disclosure. Yet preparation of proper financial reports requires an evaluation of the judgments and assumptions made by the management, along with their justification of the final choice among several alternative accounting principles. Consistency of applications in preparing accounts and coverage of all relevant financial aspects are required.

Auditors scrutinize and verify the accounts, as well as certify that the financial statements are prepared in accordance to the prescribed principles and that the accounts are free from material misstatements. It is therefore expected for the law in all countries to have put enormous responsibility on the auditors to ensure that the accounts give a true and fair view of the operations of the company. In the US, the SOX Act has put great emphasis on auditor independence. Following the Act, the US Securities and Exchange Commission (SEC) has made specific rules to put the provisions of the Act into operation. At home in India, a similar effort has been made by the

NCC, which has given a series of recommendations that have been incorporated in the Companies Bill 2009 and are awaiting parliamentary approval.
The rules and regulations regarding auditors independence framed by regulators are predicated on some fundamental principles. The NCC lists two fundamental principles behind auditor's independence namely, (i) independence of mind - which permits arriving at an informed and reasoned opinion without being affected by factors that compromise integrity, professional scepticism and objectivity of judgement and (ii) independence in appearance - which requires avoiding facts, circumstances and instances where, an informed third party could reasonably conclude that integrity, objectivity and professionalism has, or may have, been compromised. As the NCC rightly points out \for the public to have confidence in the quality of audit, it is essential that auditors should always be - and be seen to be - independent of the companies that they are auditing." Thus, when situations of potential conicts arise, the law in general has taken a sceptical view and erred on the side of caution by putting the interest of the general public before the interest of the auditor.
Similar principles are enshrined in the Code of Ethics for Professional Accountants, prescribed by the International Federation of Accountants (IFAC) which identifies five types of potential threats to auditor's independence

- Self-interest threats, which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client.
- Self-review threats, which occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client.
- Advocacy threats, which occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised.
- Familiarity threats are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests. Intimidation threats, which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism because of threat of replacement.

Building on these five fundamental principles, both the NCC and the SOX Act have put in place a number of regulations/recommendations regarding the qualification of auditors for engaging in statutory audit, the type of non- audit services that they can render, the need for rotating members of the audit engagement team, and restrictions on the extent of non-audit fees that an auditing firm can get from an audit engagement. The single purpose of these efforts has been to ensure auditor's independence.

3. Conclusion

The theoretical arguments and the empirical literature overwhelmingly suggest that auditor and audit committee independence plays an important role in the governance of companies. Currently auditor independence in India, especially with respect to rendering non-audit services and presence of conflict of interest, is largely dependent on self regulation. The Companies Act of 1956 has little to offer in this regard. Under the existing regulations there are many governance issues with respect to auditor and audit committee independence in India.

4. References

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