Revamping the Existing Code for Internal Auditors: A Necessity for Better Governance

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The role of internal auditors is vital for the successful governance of companies. The scope of auditor's responsibility has increased in this age of corporate governance. This has been due to the increase in the magnitude of operations of the corporations. Informed shareholders, an efficient regulator and numerous regulatory requirements all sharply escalate the probable liabilities faced by the Auditor's of the company.

Auditors play an important role as regards the disclosure of financial information with respect to every phase of working of a company. This financial information influences all the investment decisions of the company. The auditor has an obligation to present the financial statements as per SEBI requirements and other statutory guidelines. Certifying the compliance with corporate governance, certifying promoter's contribution etc., are other areas where the auditor's role is indispensable. Auditors have a critical role in checking financial malpractices by qualifications and effectively disclosing all germane financial information such as mis-utilisattion of funds. Further to ensure transparency in the entire mechanism the role of auditors is indispensable. Hence, the system of governance should be such that the auditors are efficient enough to perform their tasks to the maximum of their capabilities.

In this article, we propose to analyse the responsibilities and liabilities of internal auditors in cases of financial scams and to formulate an ideal code for the working of auditors to prevent any lapse in the system. We aim to achieve this by identifying the loopholes in the present code and incorporating the regulations of different countries to evolve a foolproof system.

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I. Present Regulatory Framework in India

In India, auditors are primarily regulated by the Institute of Chartered Accountants of India (hereinafter referred to as ICAI), the Companies Act |1956), and the SEBI Act of 1992. The ICAI also sets up ethical, accounting, and professional standards.[1] The auditors are responsible to report and disclose the true financial position of the Company. The auditor should prove that he exercised due professional diligence while discharging his duties and that he was not grossly negligent at any stage of conducting the audit.

ICAI: The ICAI is empowered to cancel or suspend the registration of the auditors in cases of breach of the code of conduct[2], or any other professional misconduct.[3] The method of governance followed by ICAI is that of Self-Regulation as it comprises of professionals of the same fraternity. The Chartered Accountant's Act is not a penal statute and the only sanctions that it can impose are either deregistration of erring members and/or reprimanding them.[4] It has been witnessed that ICAI is seldom harsh on members and metes out punishments quite rarely. There is no provision for auditors to be sued for incorrect auditing as well. The institute's laxity in taking any strict measures against auditors questions the worth of the self-regulatory mechanism.

COMPANIES ACT: The Companies Act requires the auditor to make a report with respect to the financial affairs of the company, to the members of

[1] Section 22 r/w Second Schedule of the Chartered Accountants Act, 1949 : L.M. Sharma, *"Professional misconduct by Auditors",* 3 Comp.L.J. 81(1992). [3] Section 8 of the Chartered Accountants Act, 1949 * Section 21(4) of the Chartered Accountants Act, 1949

the company in general meetings of the company.[5] The auditor also has the additional duty to report to the shareholders whether in his opinion the company has properly kept the books of account or not.[6] An auditor is liable to the members or investors of a company for any loss suffered by them due to the auditor's negligence.[7] The auditor can also be held liable for making any false statement in his report that the balance sheet presents the true and fair view of the company's financial affairs. However, what is shocking to see is that the maximum penalty which can be imposed on Auditors is an insignificant amount often thousand rupees.[9] The procedure for the formation and functioning of audit committees has been laid down by The Companies (Amendment) Act, (2000).[10] Further the Company Auditors Order, 2003 brought under the Companies Amendment Act, 2003, also increased the obligation of auditor. This order imposed on the auditors a duty to maintain greater corporate disclosure.

SEBI: The next important source of conduct of auditors is provided by SEBI. The Naresh Chandra Committee on Corporate Audit and Report played a lead role in reforming the auditor's position in India.[11] Clause 49 of the Listing Agreement requires listed companies to set up audit committee. SEBI lays down the disclosure norms for the companies while submitting

[5] Section 227, the Companies Act, 1956
[6] Suzanie Chua, *The Auditors Liability in Negligence in Respect of the Audit Report,* [1995] J.B.L.l, See Also Paul L. Davies, *Gower and Davies Principle of Modern Company Law,* Sweet & Maxwell, London (2003), p. 583.
[7] Section 227 of the Companies Act, 1956
[8] Section 628 of the Companies Act, 1956
[9] Section 233 of the Companies Act, 1956
[10] Section 292 A of the Companies Act, 1956
[11] Statutes, *"Naresh Chandra Committee on Corporate Audit and Governance"* as quoted in 3 Corporate Law Cases. 199 (2003).
[12] See Corporate Governance in Listed Companies -Clause 49.

their audit report. Auditors, being in a fiduciary relationship with the company[13], are required to submit the correct position of the annual financial statement of the company with SEBI. As opposed to the International scenario wherein auditors have a liability to the market regulators, the case in India reveals the opposite. There is no provision for accountability of the Auditors to SEBI.

In the light of the Satyam scandal, SEBI set up the SEBI Committee on Disclosures and Accounting Standards (SCODA) in Mumbai on January 9, 2009 which recommended that a peer-review of the working papers (relating to financial statements of listed entities) of auditors would be conducted in respect of the companies constituting the NSE - Nifty 50 and the BSE Sensex.

II. Best Practices followed in Other Jurisdictions

The recent Satyam Scandal, a black day in the history of the stock market brought to light the laxity in Indian laws due to which a company like Satyam with auditors like PricewaterhouseCoopers Inc. could get away with such a huge scam for so long, leaving the shareholders and the employees in tatters. This just highlights the carelessness on the part of the law makers in India, not to have taken precautionary steps even after huge financial scams such as Enron and Worldcom. A need thus arises to analyse the laws of various countries to understand the regulatory framework around the world.

[13] R.Baxt, *Modem Company Auditor: A Nineteenth Century Watchdog,* 33 Modern Law Review 413 (1970).

A. United States of America

The consciousness about the role of Auditors in Corporate Governance came to the United States after the huge and complicated financial scam of Enron. Enron was one of the biggest energy companies concerned with energy distribution throughout USA. It declared bankruptcy in 2001 and it was found that it had been sustained for long by systematic fraud.[14] It became synonymous to improper accounting and corporate fraud in 2001. Their recorded profits were inflated and completely fabricated; they created their own related companies to absorb debt and to take the losses from unprofitable entities off their public accounting books.[15]

The various financial scams like Worldcom and Xerox entailed the Enron Scandal leading to the passing of a legislation called the Sarbanes Oxley Act, 2002 (hereinafter referred to as the Act) to introduce various safeguard measures in order to prevent such financial scams.

This Act introduced various standards for auditors; their responsibilities and liabilities were escalated as they were found to have played a major role in these scams. A few striking provisions of the act are that, it mandates the creation of a Public Company Accounting Oversight Board and this board has

[14] W. Steve Albrecht, *Business Fraud (The Enron Problem),* American Institute of Certified Public Accountants, New York, 2005 available at: www.csb.uncw.edu/people/eversp/classes/BLA361/OtherMtls/Financial%20Statement%20Fraud.Enron.AICPA.ppt, *Last Visited on lO"l March.2009*

[15] Christopher Bowe & Joshua Chaffin, *Problem for All of Corporate America, Knock-on Effects,* Financial Times, June 27,2002; Last visited on 9* March,2009

William S. Lerrach, *Plundering America: How American Investors got taken for trillions by Corporate Insiders,* 8 STNJ L BF 216

been empowered with a lot of control over auditing activities.[17] This Act introduced certain provisions for transparency of financial information given out by the company. It mandates the CEO and CFO of each public company to certify the accuracy of information, especially financial information, contained in the company's annual report and other reports filed with the Securities Exchange Commission.[18] It requires each annual report to contain an assessment of the management's internal controls and procedures regarding financial reporting.[19] It imposes a requirement on each company to adopt a code of ethics for senior financial officers.

It provides for the protection of Corporate Whistleblowers and promulgates severe sanctions for obstruction of justice, fraud and retaliation against whistleblowers with potential prison terms extending to 20, 25 and 10 years respectively.[21] It also creates audit committees, which are independent and are directly responsible for everything related to the company's auditors. Under the Act^ it is unlawful for any person to fraudulently influence, coerce, manipulate, or mislead any accountants doing the audits for the company. This Act affects all the companies listed in the US and so brings under its umbrella the foreign corporations well, which entails mixed responses.[24] The Federal Sentencing Guidelines are also to be reviewed for enhancement of

[17] Section 101, Sarbanes Oxley Act. This board looks into the audit of public companies, establish audit report standards and rules, and inspect, investigate and enforce compliance by registered public accounting firms. It can alsp impose huge penalties as empowered under Section 105(4) of the Sarbanes Oxley Act. "Section 302, Sarbanes Oxley Act "Section 404, Sarbanes Oxley Act ^Section 406, Sarbanes Oxley Act

[21] Sections 802, 806 and 807, Sarbanes Oxley Act

[22] Section 301, Sarbanes Oxley Act

[23] Section 303, Sarbanes Oxley Act

[24] Robert Charles Clark, *Corporate Governance Changes in the Wake of The Sarbanes Oxley Act: A Morality Tale for Policy Makers Too,* 22 Ga. St. U. L. Rev. 251

fraud and obstruction of justice sentences and for white collar criminal offenses.[25] Therefore, the role of independent auditors has been redrafted to ensure that the corporate accountants reveal to investors the true substance of the deal.[26]

Sarbanes-Oxley addresses, in detail, accountability for corporate and criminal fraud, white-collar crime penalty enhancements, and corporate responsibility.[27] The Act comprehensively provides a strong penal framework, which would force the managers to adhere to the principles of corporate Governance due to fears of sanctions. It has provided a machinery for penalising the white collar crimes effectively, which is much needed in the current political and economic environment anywhere.

B. United Kingdom

According to the law in the United Kingdom, the auditors are primarily held not liable for the detection of any financial fraud. The Companies Act, 1985 in the UK compels auditors, in their contracts with companies, to limit their liability[30]. It also proposes to impose contributory negligence on directors and employers for failure to co-operate with the auditors. The Act

[25] Sections 804 and 805, Sarbanes Oxley Act
[26] Cristina Michelle De Celestino, *Sarbanes Oxley, and Corporate Greed,* 15 U. Miami Bus. L. Rev. 225
[27] Sarita Mohanty, *Sarbanes Oxley: Can one model fit all,* 12 New Eng. J. Int'l & Comp. L. 231
[28] Allen Merrill, *B for Asia Financial Sector,* Business Times , Jan. 18, 2002, Cited from: http://www.bain.com/bainweb/publications/publications_detail.asp?, Last visited on 10th March,2009
[29] Mohammed B. Hemraj, *Preventing Corporate Scandals,* Journal of Financial Crime, 2004, cited as J.F.C. 2004, 11(3), 268-276
[30] Section 310 of the the Companies Act, 1985

also imposes duties in relation to the auditors . Although the primary liability rests with the management of the company, the auditors have a liability to detect serious misstatements in the financial statements leading to a fraud.

According to the Auditing Practices Committee's (APC) guidelines in use England, if an auditor is unable to unveil a fraud, it does not mean that he has failed to perform his duties. However, neither the company nor the auditors, can be condoned for the same.[33] This shows that there are certain duties which are" imposed upon the auditors by virtue of these guidelines. These guidelines encourage the auditors, being in fiduciary duty with the shareholders of the company, to take a proactive role of whistle-blowing. At the same time, it also helps them to maintain the thin line between confidentiality of their client and bringing to light their illegal practices.[34] Hence, in the UK the guidelines for the practitioners emphasize that the job of the auditors is not to detect frauds but to look into financial compliances of a companies.

C. *AUSTRALIA*

The Professional Standards Act, 1994, in Australia tries to limit the auditor's liability for negligence[35]. The Act lays down that auditors are liable to parties who reasonably rely on their reports. The Act provides that the auditors must have a prescribed amount of professional indemnity insurance

" Section 235 of the Companies Act, 1985

[32] Waller, D. (1990) *Auditors Will Have to Become Whistleblowers,* Financial Times, 1st March (8)

[33] *Caparo Industries pic* v *Dickman & Others* [1990] 1 All ER 568

[34] *Supra note 21*

[5] Helen Anderson, *A Different Solution to the Auditors Liability Dilemma,* 8 Bond LawReview.72. (1996)

or have a minimum amount of business assets. Further, it provides for a proportionate distribution of liability between auditors and directors. The task of monitoring and approving schemes which limit the liability falls on the Professional Standards Council which is established under the Regulation.

Australia is currently facing a demand for limiting the liability of auditors. Proposals like capping the amount of liability, reforms to the law of joint and several liability and the introduction of limited liability partnerships are currently some of the most debated topics in Australia.

D. European Union

The European Commission has issued a Recommendation concerning the limitation of auditors' civil liability.[37] The Recommendation leaves it to Member States to decide on the appropriate method for limiting liability. These methods include- cap method, proportionate liability method, etc. The member countries have been given the option to choose any method which suits their legal environment. The Recommendation introduces key principles to be followed by Member States when they select a limitation method, to ensure that any limitation is fair for auditors, the audited companies, investors and other stakeholders.

1. The limitation of liability should not apply in the case of intentional misconduct on the part of the auditor;

[36] Part 6 of Professional Standards Act, 1994

[37] *Commission Recommendation of 5 June 2008 concerning the Limitation of the Civil Liability of Statutory Auditors and Audit Firms* (notified under document number C(2008) 2274): Cited from http://ec.europa.eu/internal_market/auditing/liability/index_en.htm Last visited on 10th March,2009

2. A limitation would be inefficient if it does not also cover third parties;

3. Damaged parties have the right to be fairly compensated.[30]

III. Comparative Analysis of Laws & Reforms Suggested to Revamp the Code In India

This part of the article focuses on the comparison of the laws of various countries with Indian Laws and brings out the changes which must be incorporated in Indian Law. Though Clause 49 of the listing agreement is a comprehensive regulation which aims at achieving Corporate Governance, it misses out some essential factors which may help in attaining the object of the provision.

A. Regulatory Mechanism

It is necessary that the auditors work in the bests interests of the shareholders of a company. Therefore, they need to be effectively regulated. The Sarbanes Oxley Act of 2002 has led to the formation of a Public Company Accounting Oversight Board (PCAOB)[39] to look into all the auditing practices, and such a regulatory mechanism is very essential for India. The method of self-regulation being followed by the ICAI has failed as stated earlier and multiplicity of regulatory authorities is a major problem in India.[40] Therefore, the powers should be consolidated and vested in one authority for better governance and effective impositions of sanctions.

[58] Ibid

" *Supra Note* 13 at 217

*° N. Vittal, *Issues in Corporate Governance in India* (Paper for publication in the 5th JRD Tata Memorial Lecture Series), cited from http://www.docstoc.com/docs/1021293/Issues-in-Corporate-Governance. Last visited on 10* March,2009

Moreover, ICAI is not an independent body. It ends up being deficient in its duties. This can be remedied by making an independent body like PCAOB.

Another important procedure that should be incorporated in the Indian auditing system is that of dual reporting which is followed in the UK, where the filing is to be done to the independent and the most powerful board (a requirement of which has been mentioned above) along with the market regulator to maintain a dual check. Moreover, some provisions should be introduced through which a company can claim damages from an erring Chartered Accountant in case he is involved in a fraud, as in the UK.[41]

B. Ensure Independent Auditing

The major fault in the system of Governance followed in India is that the auditors are expected to be independent in spite of the fact that they are appointed by the companies themselves. Hence, the element of independence is being compromised with.[42] On the other hand, the Sarbanes Oxley Act of the USA mandates the setting up of an audit committee, which is independent in nature and looks after the appointment of auditors.[43] Therefore, such provisions need to be incorporated for the employment of auditors by a company in India as well. Moreover, according to Section 201 of the Sarbanes Oxley Act, an auditor should not be allowed to perform non-audit functions. Financial audit and consultancy services are to be completely separated from

[41] Virendra Jain, *Debate: Do India's Audit Rules need to be overhauled,* Business Standard, February 4, 2009;
[42] Thomas C Pearson, & Gideon Mark, *Investigations, Inspections and Audits in the Post SOX Environment,* 86 Neb. L. Rev. 43
[43] Section 301, Sarbanes Oxley Act, 2002

each other.[44] This is necessary as auditors charge much higher consultancy fees than the audit or accountancy fees, and become spectators of all the financial manipulations the company does. At times, they even assist the companies in financial manipulations. The auditors face pressure to retain strong clients and hence, they tend to become advocates of their client's financial issues rather than "watchdogs" of their accounts. This goes completely against the role of the auditors.[45] The solution is to provide a mandate under Clause 49 of the Listing Agreement to disallow auditors from acting as consultants or performing any other non-audit functions for the same company.

C. Change in Auditors

It has been observed that the companies which work in consonance with the Corporate Governance principles keep changing their auditors at regular intervals. This has not been followed in India. In the Satyam Scandal, PricewaterhouseCooper had been the auditor of Satyam since the past eight years. This was never questioned.[46] Therefore, a provision can be added either to Clause 49 of the Listing Agreement or in the Companies Act, 1956 to change auditors after a fixed interval of time so as to avoid any malpractice. This can be done in line with the Sarbanes Oxley Act, which provides for the rotation of the lead audit partner every five years[47]. This can also be made

" *Independence: "Who Wakes Up the Bugler"'* Accounting Today, December 15, 1997
[15] *Supra F.n. 12*
[16] *Satyam Audit Reports may be deemed unreliable: PwC,* Economic Times, 14 January 2009
" Section 203 of the Sarbanes Oxley Act

mandatory, ensuring fair auditing practices in India. This argument is also supported by the Naresh Chandra Committee Report.

D. Whistle -blowing to be made mandatory

While Clause 49 of the Listing Agreement speaks about whistle blowing, it does not make it mandatory. However, the provisions of Sarbanes Oxley Act are different and they encourage whistle-blowing to the extent that they penalize someone who decides to go against the whistleblowers with heavy penalty.[4] Even in the case of the UK, whistle-blowing is encouraged in accordance with the APC guidelines and therefore, for effective corporate Governance and to prevent any further frauds, it is very necessary that whistle-blowing be made mandatory. In the opinion of the authors, it would be efficient to bring out an amendment in the Chartered Accountants Act and introduce a whistle-blowing provision in the code of conduct for auditors to avoid any financial malpractice. The power to regulate the conduct of the auditors must be completely regulated by the ICAI. This should further be complemented by converting the non-mandatory clause for whistle-blowing under Clause 49 of the Listing Agreement to mandatory. However, whistle-blowing is a vulnerable area due to no norms for identity protection, so it should be carefully regulated.

[48] Government of India, *Naresh Chandra Committee Report on Corporate Audit and Governance,* (Ministry of Finance, 2002)
[49] Section 806, Sarbanes Oxley Act

IV. Conclusion

The present economic scenario in India attracts immense growth opportunity for companies, with huge scandals of the magnitude of Satyam staring in the face. Therefore, along with growth what is important is sustainable growth so that investors do not lose faith in corporates. Hence, we have suggested a better regulatory framework for the regulation of auditors, incorporating best practices of various jurisdictions, as the current regulatory system is inadequate in light of the pace of growth of the economy. We have provided a framework encouraging proactive conduct, accountability, sanctions and sincere application of laws for the fair success of a company, thereby, building a stronger economy.