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WHETHER THE INDEPENDENCE OF EXTERNAL AUDITORS CAN SERVE A CORPORATE GOVERNANCE ROLE IN SAFEGUARDING ACCOUNTING INFORMATION?

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ABSTRACT

The system whereby entities are often directed and controlled, of which the board of directors is in charge of, is termed as corporate governance. This frequently identifies with what the organization chooses as its key points, providing the leadership to put them into effect, regulating the administration of the business and answering to investors on their stewardship.[1]

"Corporate governance essentially involves balancing the interests of a company's stakeholders which includes shareholders, management, customers, suppliers, financiers, government and the community[2]*."*

To do so, the main prerequisite is to have a transparent, clear, concise and real picture of the company's financial affairs. In the near past, there have been several issues that place the limelight on the corporate governance practices in India. A few of these include the IL&FS default crisis, PNB scams, etc. that left a rippling effect across broader markers and in turn led to fear amongst the stakeholders.

Even before the exceptionally renowned Satyam scam shook the Indian corporate sector, the world had its share of a breakdown of corporate governance in the form of Parmalat, Enron, Qwest, Global Crossing, etc., all from auditing spaces that shook the very fundamentals of corporate governance. These scams made auditing in India an essential part of the hierarchy of ideal corporate governance structure.

INTRODUCTION

Having laid out how auditing came into the picture for corporate governance, it becomes the management's responsibility with which audits are conducted. And hence without the management having responsibility for the financial statements, the demarcation line that determines the auditor's independence and objectivity regarding the client and the audit engagement would not be as clear.

[1]ICAEW, *What is corporate governance?*, (December 2010), https://www.icaew.com/technical/corporate-governance/principles/principles-articles/does-corporate-governance-matter.

[2]Hans Alagoa, *Managerial Decision-Making in International Business: Corporate Governance Issues in Emerging Markets*, SSRN (August 7, 2015) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2641005.

Auditing is important to well-functioning equity and debt markets through its use in contracts that reduce companies' agency costs[3]. This is likely to be especially true for companies in markets that are in a development stage or do not have strong legal and financial institutions in place that help to reduce agency conflicts. Similarly, in countries where audit institutions are weak, accounting numbers supplied by companies could be viewed as less reliable and relevant by investors, lenders, and other stakeholders. This suggests that a stronger audit profession can serve to improve the quality of financial information in emerging markets through an infrastructure that supports high-quality auditing.[4]

With an advent rise in the necessity of independence of auditors, the prior practice of relying on accountants from audit firms to assist in reconciling accounts, preparing the adjusting journal entries and writing financial statements has come to a standstill. Relying on the audit firm often made sense from the perspective of efficiency and cost containment, especially for smaller companies.

The difference this has brought about includes increased regulations that complicate an already often misunderstood set of standards. One of these states that auditors are not permitted to conduct non-attest services such as tax or consulting services.

The outside, independent auditor is engaged to render a conclusion on whether an organization's fiscal summaries are introduced decently, in every single material regard, as per the money related detailing system. The review gives clients, for example, banks and speculators with an upgraded level of trust in the budget reports.

To form the opinion, the auditor gathers appropriate and sufficient evidence and observes, tests, compares and confirms until gaining reasonable assurance. The auditor then forms an opinion of whether the financial statements are free of material misstatement, whether due to fraud or error.

In order to properly appreciate the value of this question, it is best understood with the post the basics being laid out, of the functions of the auditor, their roles, etc.

[3]ROSS L. WATTS, JEROLD L. ZIMMERMAN, POSITIVE ACCOUNTING THEORY, (Prentice-Hall Inc., 1986).

[4]Paul N. Michas, *The Importance of Audit Profession Development in Emerging Market Countries*, 86 The Accounting Review, No. 5, 1731-1764 (September 2011).

ROLE THAT AUDITORS PLAY TO DIFFERENT PARTIES:[5]

TO SHAREHOLDERS - whether the management is transparent about the strategic value proposition of the organization or not will be a duty upon the auditors. This is key, as it embeds much of the detail of how the company believes it is going to make money over the next few years. Auditors must ensure that a firm's communication is balanced. They have a responsibility to draw attention to any unusual aspect of the audit findings, especially if management is only sharing part of its performance story.

TO CLIENTS - They will need to examine stakeholder expectations closely and consider how organizations are meeting them. The challenge for any organization is to bring together the whole story of its performance (the financial statements only represent one aspect of this) and consider how it can be used to provide stakeholders with more confidence.

SOME OF THE MORE IMPORTANT AUDITING PROCEDURES INCLUDE[6]:

- Inquiring of management and others to gain an understanding of the organization itself, its operations, financial reporting, and known fraud or error
- Evaluating and understanding the internal control system
- Performing analytical procedures on expected or unexpected variances in account balances or classes of transactions
- Testing documentation supporting account balances or classes of transactions
- Observing the physical inventory count
- Confirming accounts receivable and other accounts with a third party

At the completion of the audit, the auditor may also offer objective advice for improving financial reporting and internal controls to maximize a company's performance and efficiency.

[5] Isabelle Santenac & Hywel Ball, *The future of assurance: The role of audit in society*, Ernst & Young LLP, (2016) https://www.ey.com/Publication/vwLUAssets/EY-financial-services-viewpoints-audits-role-in-society/%24FILE/EY-financial-services-viewpoints-audits-role-in-society.pdf.

[6] Gelman, Rosenberg & Freedman, *What an Auditor Does and Doesn't Do*, (December 16, 2011) https://www.grfcpa.com/resource/auditor-responsibilities/.

FUNCTIONS THAT AUDITORS DO NOT UNDERTAKE:[7]

For a clear picture of the role of external auditors, it helps to understand what you should not expect auditors to do. The emphasis is on "independent." The responsibility for financial statement presentation lies squarely in the hands of the company being audited and not the auditors.

Auditors are not a part of management, which means the auditor will not participate in the activities that are exclusively management-oriented such as:

- Authorize, execute or consummate transactions on behalf of a client
- Prepare or make changes to source documents
- Assume custody of client assets, including maintenance of bank accounts
- Establish or maintain internal controls, including the performance of ongoing monitoring activities for a client
- Supervise client employees performing normal recurring activities
- Report to the board of directors on behalf of management
- Serve as a client's stock or escrow agent or general counsel
- Sign payroll tax returns on behalf of a client
- Approve vendor invoices for payment
- Design a client's financial management system or make modifications to source code underlying that system
- Hire or terminate employees

Now that the functions of an auditor have been clearly laid down, the next question that arises is how exactly it affects corporate governance:[8]

- **Maintain Strong Relationship With Regulators-** The efforts put in by an external auditor helps in fostering a good relationship with regulators. Mostly if the companies and agencies have transparent operations, the regulators are supportive of them. External auditors evaluate the compliance with the regulations of a company's

[7] *Ibid.*

[8] ACCA global, *Corporate Governance and its impact on audit practices*, https://www.accaglobal.com/in/en/student/exam-support-resources/professional-exams-study-resources/p7/technical-articles/corpgov-audit.html.

organization. Once an auditor attests to the company's disclosures, it is more likely that the regulators also show their trust towards them.

- **Promote Accountability-** It is often seen that the degree assessing controls and tasks as a job of reviewers(auditors) improves corporate administration. Measures and strategies presented by outer examiners are intended to constrain responsibility in the work environment.

  For instance, if the fiscal summaries are controlled by expanding figures or cooking bookkeeping numbers, inspectors could prescribe punishments. For such acts, punishments could incorporate stripping the administrator of his position or his remuneration, diminishing yearly rewards or annuities. Thus, if the reviewer has the scarcest piece of doubt of the lawfulness and respectability of a record or exchange, this/her obligation to explore and report it, before he ensures it to be valid.

- **Crisis Management-** By developing efficient crisis management plans to be used in the event of allegations of corruption or fraud, an auditor helps in ensuring good corporate governance. Typically, the idea is to assign responsibilities to different officials of the administration. This provides that if the company becomes involved in a financial crisis, those officials have an action plan that can be used in making sure that confidence among investors is sustained. Control measures that are to be used with the media and law-enforcement officials are part of the crisis management plans.

- **Represent Interest of Shareholders-** One of the numerous critical jobs of expert auditing in India in corporate governance is to secure the interests of investors and partners of an organization. It is made conceivable by directing autonomous reports by the examiners and not being affected by the organization.
  External auditors are required to express the funds of the organization and authenticate the legitimacy of financial reports that may have been discharged. They must guarantee that the board gets precise and solid data. The board may likewise scrutinize the perspectives communicated and an appraisal made by the evaluator on the fittingness of the standards utilized by the organization.

- **Risk Assessment and Mitigation Planning-** Auditors help in promoting corporate governance by conducting a period risk assessment. External auditors reassess the security measures that an organization has set up against defilement or corporate misrepresentation.

  Moreover, they additionally dissect the overall hazard resistance of the organization and the endeavours that the organization has made towards decreasing the dangers. For instance, if an administration office or an organization has a framework with a failing to meet expectations informant, at that point the endeavours might be made to enhance the framework being referred to.

All the above points are just a few factors that point to how auditing as a whole is so very vital to Corporate Governance practices. These help us understand why the independence of these auditors is crucial, owing to the significance of the role played by them.

DOES THE UK HAVE INDEPENDENT AUDITORS?

Under company law in the United Kingdom (U.K.) external auditors are designated by shareholders of limited liability companies and answer to them. There are equivalent regulations for a number of different types of organizations with the principle being that the external auditor is not influenced by the directors of the organization.

One factor possibly undermining the independence of the external auditor is the potential power of the company directors "*who effectively appoint and dismiss the external auditors with the appointment or dismissal merely being ratified by the shareholders at the annual general meeting*". [9]

It is also argued that the joint provision of other services and audit services may result in the auditors being less likely to disagree with management[10] and the competitive pressure to secure audit work has been regarded as likely to lead to more compliant auditors.[11]

[9]W.M. Mclnnes, *Auditing into the 21st Century*, Institute of Chartered Accountants of Scotland (1993).
[10]A. Craswell, *'Auditing Pricing in Australia 1980-1989'*, Australian Accounting Review, 28-33 (1992).
[11]A. Briloff, *'Our Profession's "Jurassic Park"'*, The CPA Journal, 26-28 (1994).

There have been many similarities with the proposals and the Board for Chartered Accountants in Business, in considering possible mechanisms to remedy the perceived weaknesses of regulations, posed three questions[12]:

1. Should there be a prohibition on firms undertaking work other than audit for their audit clients?
2. Should there be a compulsory rotation of audit firms, after a fixed period of saying anything between 5 and 12 years?
3. Should responsibility for the development of auditing standards and guidelines be distanced from the Institute of Chartered Accountants in England and Wales?

In the end, it was decided that there would be a need to prohibit any form of additional work such as a requirement of compulsory rotation of audit firms that would in turn increase clients' costs, reduce efficiency and place restrictions on the freedom of the client to make decisions on such services. Additionally, they had also decided against the establishment of an additional body that would control auditing practices, which would otherwise lead to a bureaucratic, inflexible framework, that did not capitalize upon the experience of the profession.

WHAT ARE A FEW REASONS FOR THE ABSENCE OF INDEPENDENCE OF AUDITORS?

Although there are questions raised on the independence of auditors, there is little doubt as to what the position should be and "*the auditor's responsibility is to the shareholders and not, as some directors appear to believe, to the Board of Directors*"[13]. Indeed, this independence is the very substance of the relationship and "*An audit can only be effective if the auditor is independent and is believed to be likely to report breaches of the contract between principals (shareholders and lenders) and agents (managers)*"[14].

A number of factors have been identified in the literature which may detract from auditor independence, such as the possible lack of stricter regulations, the nature of the auditor-client

[12] Board for Chartered Accountants in Business, *The Status of the Audit/Client Relationship*, Institute of Chartered Accountants in England and Wales (1990).
[13] E. Stamp, *Informing the Shareholders: Published Accounts and Reports,* Accountants Journal 130-135 (Novernber 1965).
[14] S. Fearnley & M. Page, *Auditing Regulations in the U.K.: Lemons, Cadillacs and Free Riders,* EAA Conference Paper, 7 (April 1995).

relationship[15], and the provision of non-audit services and competitive pressures leading to what has been termed predatory pricing or lowballing.[16]

The nature of the personal relationship between directors and auditors has led to what has been termed the "*Familiarity Threat*"[17], which undermines external auditor independence. This familiarity threat can be compounded in situations where the current company finance director was formerly employed by the firm doing the external auditing, a not uncommon occurrence. A study[18] on the effects of client employment on auditor independence suggested that the past position of the ex-auditor, his/her current position in the company, the time lapse between auditing the client and becoming an employee of the company and the nature of the last audit opinion could have an effect on the public perceptions of auditors' independence.

An interesting fact that often comes out is that the big 5 auditors have international reputations and are generally perceived to be more independent than are local auditors. Specifically, firms are more likely to appoint Big 5 auditors when their perceived entrenchment problems, captured by the degrees of the voting power of the largest owners, are more severe. There is also weak evidence that auditor choice is associated with the incentive alignment effect measured by the controlling owners' cash flow rights.[19]

CONCLUSION

Therefore, from all of the above mentioned we see that it is not uncommon for the auditor to make suggestions about the form and content of the financial statements, or even assist management by drafting them, in whole or in part, based on information provided by management. In those situations, management's responsibility for the financial statements does not diminish or change.

[15] A. Goldman & B. Barlev, *'The Auditor Firm Conflict of Interests: Its Implications for Independence'*, The Accounting Review, 701-718 (1974).
[16] V. Beattie & S. Fearnley, *'The Changing Structure of the Market for Audit Services in the U.K. - a Descriptive Study'*, British Accounting Review 26(4), 301-322 (1994).
[17] Chartered Accountants Joint Ethics Committee, *The Framework: A New Approach to Professional Independence*, Consultative Paper, Institute of Chartered Accountants in England and Wales (1995).
[18] H.C. Koh & P. Mahathevan, *'The Effects of Client Employment on Auditor Independence'*, British Accounting Review 25 227-242 (1993).
[19] Joseph P. H. Fan & T. J. Wong, *Do External Auditors Perform a Corporate Governance Role in Emerging Markets? Evidence from East Asia*, 43 Journal of Accounting Research, No. 1, 35-72 (Mar., 2005).

Publicly reported accounting information, which measures a firm's financial position and performance, can be used as important input information in various corporate governance mechanisms.

External auditors can potentially provide assurance of the quality of publicly reported accounting information, which in turn limits the entrepreneur's ability to manipulate accounting information and hence his or her ability to extract wealth from outside shareholders[20] such as managerial incentive plans. Whether and how reported accounting information is used in the governance of a firm depends on the quality and credibility of such information. And hence the independence of these external auditors proves to be very vital in order to achieve Corporate Governance goals.

[20]The Securities Exchange Commission of Thailand Corporate Governance Report (1999), The Asian Corporate Governance Association research report (2000).