

Of war, truth and institutions

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People may love a good war; nevertheless, war is a terribly damaging undertaking where neither the victim nor the vanquished comes out unscathed.

More importantly, war hysteria threatens to overpower logic and reasoning. The current turmoil in the Indian economy caused by the events at Satyam has all the makings of a war. And like in any other war, everything seems to be fair even when it is patently unfair.

So we have a situation where cartoonists, columnists, TV talk show hosts, guests and MTV viewers have become experts on the intricacies of corporate audit and governance and deliver a verdict on people and establishments of repute and long standing. And in an election year who knows where public outcry and political grandstanding of this nature can land us?

There seems to be insufficient understanding among the general public about the roles and responsibilities of outside auditors and directors.

The responsibility for running a company lies with the management. Management is also responsible for maintaining books of accounts and preparing annual accounts. An auditor steps into the picture to examine the said books and to pronounce an opinion whether the financial statements have been produced by the company in accordance with generally accepted accounting principles and that they reflect a true and fair view of the business.

In doing this work, the auditors are required to follow generally accepted auditing principles and other standards. A corporate audit is a complex and technical affair carried out under numerous codes, laws and statutes. A routine audit is not designed to uncover fraud.

If there is active management collusion in carrying out an elaborate fraud, chances of discovery are even lower, unless one accidentally stumbles upon it. This is not to suggest that audit firms can be excused for relaxing their vigilance or can be condoned for not exercising due care.

The scams of recent years like Enron, Global Crossing, Tyco, Parmalat, etc., had led to severe new regulations in the US and faithfully copied in most other countries. Yet, there are very few ways of preventing frauds altogether and most frauds are detected only after the fact. This makes the job of auditors even more challenging because they have to tread a fine balance between being watchdogs and being bloodhounds.

The responsibility for corporate oversight is multi-layered with several components such as Sebi in India, SEC in the US, independent directors, auditors and regulators, among others. Yet frauds occur in all economies, not always due to audit oversight but perhaps due to circumventing different layers of checks and balances on part of company personnel.

For instance, multiple layers of regulations could not prevent upheaval in United States in huge banks and companies like Lehman Brothers, Bear Stearns, AIG or Merrill Lynch due to the sub-prime mortgages or unregulated instruments like credit default swaps. Or fraud could be executed in a simple manner like Madoff's Ponzi-type multi-billion dollar scam.

Likewise, independent directors form just one of the layers of oversight mechanism and cannot be expected to detect active fraud within a company. They have no independent means of verifying the truthfulness of management representations and must rely on information received from within the company.

It helps no one if independent directors take an adversarial position vis-a-vis management and approach everything with a suspicious bent of mind. Their purpose on the Board of a company is to add value depending on their area of expertise. To expect independent directors, who, by the very term are independent of management, to figure out active fraud from an annual average of six board sittings is nothing short of naiveté.

Well-established, reputable audit firms have a multi-tiered system of checks and balances and rigorous processes that help increase comfort levels of users of audited financial statements. If the Satyam episode exposes a chink in this armoury, it is imperative that the source of the problem is located, systemically rectified and where necessary, changes made in external codes and internal processes so that user confidence in the system is restored immediately.

As the country marches ahead economically, it needs several institutions that can handle work of increasing complexity. Such institutions need decades of patient growth to be able to deliver quality work and this includes regulators, lawyers, auditors, etc.

It helps no one if war frenzy brings down any of the existing great institutions because the cost of building alternative credible institutions will be prohibitive in terms of lost time and monetary costs. Already comparisons are being made between Price Waterhouse (auditors of Satyam) and Arthur Anderson (auditors of Enron). Public memory is short but three years after Arthur Anderson was forced out of business, the US Supreme Court cleared the firm of all criminal charges.

However, by then a great institution was lost to the world which also meant one less credible competitor among auditing firms and that does not help businesses in general. It is unfair that our established regulatory institutions have not been given time to complete their probe before judgements and verdicts have been pronounced in a media trial.

India is justifiably proud of its free press; however, there is line of distinction between investigative journalism and sensationalism or 'breathless reporting style' that sometimes gets blurred perhaps also because of intense competition among media houses themselves. Auditing firms in India are subject to a code of conduct that prohibits them from speaking in public about any matter that may betray client confidentiality. For a service industry like software, legal or auditing practice the reputational risk that a media war inflicts carries disproportional levels of collateral damage.

Mercifully, In India, it is an established tenet of our jurisprudence that a person is presumed innocent unless proved otherwise. It is time to take a step back and let investigative agencies complete their work and give recommendations. This will only help in strengthening our own institutions and legal processes and pave the way for smoother journey going forward.

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