

24-Apr-2015 (04:10 PM) Nifty : 8305.25 -1.11 ACC : 1531.60 0.86 Ambuja Cement : 233.35 -1.79 Asian Paints : 771.35 -1.91 Axis f NSE BSE

MARKET STATS
As on 24/04/2015SENSEX
27437.94
-297.08
(-1.07%)NIFTY
8305.25
-93.05
(-1.11%)GOLD (MCX)
26780.00
170.00
(0.64%)USD
63.69GBPINR
96.22
0.33
(0.52%)1.20
(1.26%)

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On December 8, 2014, a Hyderabad court held four independent directors of the scam-ridden Satyam Computers responsible for dereliction of duties and fined them between R20,000 and R2.66 crore. The charges, filed by the Serious Fraud Investigation Office, had accused them of breach of various provisions of the Companies Act of 1956, inter alia, fraud and financial misstatements, misreporting in the Board's Report and Directors' Responsibility Statement, which over the years had been approved in various Board and committee meetings. This judgment defines, probably for the first time, the principles of care and loyalty that independent directors have towards a company under the old Companies Act of 1956.

Apart from fines, these directors would not be eligible to sit on Boards in the future, unless a superior court turns down

this decision. The reputational loss to these individuals, who were at the pinnacle of their profession, will probably never be recovered.

The provisions of the new Companies Act of 2013 are significantly more punitive for such breaches and the courts will probably be far more severe in their punishment in the future, perhaps even criminally indicting independent directors in extreme cases. Thus, it should serve as a wake-up call for independent directors to pause and evaluate risks and responsibilities afresh.

The situation is not very different worldwide. In October 2014, one more accounting fraud hit the headlines when UK's largest retailer Tesco publicly reported, on the basis of an internal whistle-blower alert, that it had "overstated" expected first-half profit by 250 million pounds. Predictably, it led to a financial bloodbath, wiping out 2 billion pounds of Tesco's stock market value in two days and focus was back on the role of auditors and directors.

Tesco's chairman Richard Broadbent had sought to pass the buck by saying that "the auditors didn't catch it." But information in public domain pointed to something else. Tesco's auditors had flagged off "commercial income"—at the centre of the scandal—for "risk of manipulation" in their 2013-14 report. Tesco's audit committee, however, dismissed it saying that appropriate "management controls" were in place. In Satyam's case too, the management had taken a similar stand to which the independent directors voted with their feet.

Prima facie, it would appear that while the auditors in both cases flagged off the risk, they didn't follow it through and the audit committees might not have had an informed basis for assuring efficacy of the management controls. Consequently, when the fraud surfaced, they ended up blaming each other. But, not all frauds can be hung on the auditor's door!

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More than anything, this shows the complementary and interdependent relationship between auditors and independent directors. They are both sentinels of financial integrity of a company and their responsibilities go beyond their traditional roles. Auditors, due to the telescopic view they bring to bear on financial statements, are expected to identify, assess and manage risks of misstatements and fraud. The Board of Directors and audit committees have a duty to not only define but also refine effective control environment based on the auditor's inputs.

Frauds keep tumbling out because there is a lack of coordinated functioning between auditors and Board. In such situations, there are greater chances of fraud to be detected when somebody within a company blows the whistle, than through its internal controls, monitoring or audit mechanisms—detection by chance than by design.

The Companies Act of 2013 has overhauled the governance framework to bring more transparency, responsibility and accountability to the way business is conducted to prevent fraud. Fraud has punitive consequences for management, directors and also auditors and its definition widened to include those acts that don't necessarily involve financial loss. A mere intent to mislead through public disclosures in accounts, prospectus, etc. can constitute a fraud and hence needs greater oversight.

But are Indian Boards and their auditors equipped to handle such onerous responsibilities?

Boards and audit committees of public companies in India are in a transition phase, moving towards higher levels of public scrutiny and responsibilities. It is not easy because most Boards in India have been subservient to the promoters or management and have not played the role of protectors of public interest effectively. With the threat of personal financial liabilities and imprisonment for dereliction of duty, non-executive and independent directors perform have to be more vigilant and engaged. The levels of scepticism, diligence and oversight have to be enhanced, and demonstrably so, especially when dealing with transactions affecting the interests of minority shareholders or which are profitable for the promoters at the cost of other stakeholders. There was an instance in 2014 in which two promoters of a company were paid R120 crore, about 10% of profits, while its CEO got just R1 crore. The whole process was overseen by independent directors forming the remuneration committee, presumably through the prism of reasonableness. Jury is still out on what is reasonable!

The quality of auditing is another issue and blind faith in the work done by auditors may not constitute adequate defence for the Board of Directors any more. Public Company Accounting Oversight Board (PCAOB), the oversight body for auditors in the US, routinely reviews the audit files of Indian audit firms engaged by significant subsidiaries of US-listed companies or Indian companies which are listed in US. This is one of the few measures of audit quality in India. The review results are mixed and a number of Big 4 auditors and smaller firms have shown significant deficiencies in their audits. If this is viewed as a benchmark, the quality of audits in India is alarming and mere reliance of such work by auditors as a discharge of the responsibilities of directors can have catastrophic results.

One of the reasons for deficiencies could be that auditing is no longer the most attractive proposition for young accountants, leading to huge staff turnover; for larger firms, there is an undue focus on creating documentation than doing actual tests. In most firms, audit practices and efficiency are judged by the number of man-hours saved in each subsequent year. So, the hours spent in supervision by senior staff or partners are alarmingly low.

Frauds also occur when an audit firm is long entrenched in a client and stops innovating or building elements of surprise in the audit processes. Boards need to be aware of this and evaluate the efficacy of tests and processes undertaken by auditors to determine the extent of reliance that can be placed for the quality of financial statements they approve.

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The Board's role must be executed independently and through affirmative manifestation which stands on the strength of its diligence. The bar of oversight, thus, has to be demonstrably very high. Else, Boards will keep blaming others for every failure of their duties and courts will be less forgiving each time.

By Kaushik Dutta

The author is founding director of Thought Arbitrage Research Institute, a non-profit think tank engaged in research on corporate governance, sustainability and public policy. He is also chairman of the Audit Committee of HCL Infosystems

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