Corporate audit needs to be reformed

If the stand of the audit profession is that a non-negligent and proper corporate audit will not be able to detect frauds of the size of Satyam, then the very rationale for a statutory audit is lost.

Of the many impacts of the Satyam scandal, its effect on the reputation and practices of the audit profession will be among the most profound.

The underlying problems of corporate audit, in particular the lack of independence inherent in the selection of auditors by managements, have been known for decades.

In 1986, this writer co-authored an article in *The Hindu* on “Reform of Corporate Audit”, highlighting the *serious* deficiencies and suggesting changes such as fixed tenures, avoidance of non-audit work by statutory auditors, and (where appropriate) appointment and fixation of remuneration by an authority independent of the company.

In a rejoinder, also published in *The Hindu*, the suggestions were dismissed out of hand as unnecessary by Mr N. C. Krishnan, Past President of the Institute of Chartered Accountants of India (ICAI).

Most attempts at corporate governance reform in recent years have concentrated on the Board, its composition and functioning. Reform of audit has not been a priority.

Weak audit practices

Five years ago, a group of Indian chartered accountants wrote to Ministers, civil servants and opinion makers on the risks posed by the entry of the Big Four international audit firms into India; they pointedly drew attention to what they saw as the feet of clay of these icons.

The fact that Satyam’s auditors were Price Waterhouse (and not, say “Chatterjee & Ramanathan”) will be seen as a vindication of those who saw the reputations of these firms as being based on size and international clout rather than quality.

Had the auditors been the apocryphal Chatterjee & Ramanathan, one can be sure that the international firms would have been among the first to say “we told you so” about the “poor quality and integrity of indigenous accounting firms”; FIIs and ADR investors would have been quick to see the remedy to the problem as being the appointment of “internationally reputed” auditors.

If the identity of Satyam’s auditors offers some comfort to the Indian profession, unfortunately, the specific defects that have become public do the opposite: They suggest that Indian audit practices have been weak compared to the West’s ‘best practice’.

Satyam is unusual for the simplicity of the fraud — the inflation of bank balances. The Chairman of the Western India Regional Council of the ICAI is on record as saying that “Unless there is reason to doubt, auditors, in good faith, usually accept the banker’s certificate submitted by a company regarding its cash and bank balances; however (following the Satyam episode) we may issue guidance regarding compulsory verification of cash and bank balances above a certain threshold…”

Time for a review

Twenty-six years ago, as a candidate for the Chartered Certified Accountant (ACCA) final examination of the UK, this writer used as a textbook the 1981 edition of the Manual of Auditing of Coopers & Lybrand (a predecessor firm of PricewaterhouseCoopers).

The manual said "the practice of obtaining independent certificates or reports direct from banks is essential to the proper discharge of the auditor's responsibilities".

The UK accountancy bodies had prescribed a standard letter to be sent to banks by the auditors.

The manual goes on to say "it will be necessary to obtain confirmation as to the authenticity of any letters not received directly from the bank branch concerned, and of any letters received from a bank without a request having previously been made.

In both cases, it is necessary to confirm with the bank branch concerned that the report has been prepared in compliance with the terms of the standard bank letter". If indeed Satyam had (as claimed by Mr B. Ramalinga Raju and not so far denied by Price Waterhouse) inflated its bank balances, this simple procedure would have revealed the truth.

That such a standard practice in the UK has remained an exceptional measure in India is surprising. It suggests that audit procedures in India need to be reviewed thoroughly.

Relevance of statutory audit

One danger the profession — in India and internationally — has to avoid is that of retreating into self-defensive 'peer review' or meeting 'standards' (prescribed by the audit profession for the audit profession) when these are at variance with the expectations of the investing public. Reactions from some chartered accountants in recent days have been along the lines that "accepted audit standards and procedures have been followed; in spite of that, events like this can sometimes happen.

"It does not necessarily imply any negligence by the auditor. An audit is not an investigation or a 'proof' of the correctness of the accounts; it is only a review of what is given by the management. It is the management alone which is responsible etc. etc."

The danger in this defence is that it suggests that corporate audit as carried out now is of little real value to the user of accounts.

If the stand of the profession is that a non-negligent and proper corporate audit will not be able to detect frauds of the size of Satyam, then the very rationale for a statutory audit is lost.

Public opinion and the legislature may legitimately feel that statutory audit serves little purpose and could be scrapped, leaving each company's shareholders to decide whether, and, by whom, an audit is needed. This is not a desirable outcome for the profession.

Silver lining

For long, it has been suggested that (because of India's prevailing patterns of corporate ownership and governance) if an auditor is completely honest, he cannot be successful and if he is successful, he cannot be completely honest.

Like all clouds, the Satyam episode has a silver lining. Already, there are suggestions within the audit profession of term limits and independent appointing authorities, which were considered anathema earlier.

Perhaps, Satyam will finally succeed in doing what previous scandals and calls for change have not: A long-overdue recognition in the audit profession and the Government that corporate audit needs to be reformed — providing an unusual proof of the Government of India's motto *Satyameva Jayate*.

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