Chapter 6
Regulatory Environment

6.1 Introduction

The institutional environment is very important for the growth of the capital markets and the economy of a country. They can facilitate or restrict certain transactions and determine the ability of the society to realise the economic growth. Institutions as defined by North are "a set of rules both formal and informal, devised by people to constrain behaviour and the institutional framework as matrix of formal and informal rules and their enforcement."[332] These sets of rules can range from the constitution to the private contracts. In any country organisations come into existence to take advantage of opportunities made available to them, to earn economic and other benefits. Organisations in such cases act out of their own self-interest. The self-interest behaviour of the organisations influences the institutions to make formal and informal rules, which will be accepted standards of behaviour. Institutions thus "act as a constraint(s) that human beings devise to shape human interaction."[333] Traditionally institutions that govern behaviour are usually informal that are evolved through social interaction and are either internalised or enforced informally.

Formal institutions of rules and regulations on the other hand help in facilitating exchange by reducing the uncertainties involved in a transaction. Institutions are capable of reducing the costs associated with asymmetric information through mandatory disclosures. They will reduce the transaction cost by having economies of scale and through greater competition. As the business becomes complex the need for institutional regulatory agencies become important. As we see later, technical expertise is needed to promote efficient institutions to regulate the complex activities. Having specialised institutions with technical expertise ensures proper rules and their implementation. In the recent years, greater innovations in financial instruments and other complex changes in

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[332] D.C. North, *Institutions, Institutional Change and Economic* Performance, (New York: Cambridge University 1990) at 4

[333]D.C. North supra note 1 at 4

the business environment have enhanced the market efficiency. On the other hand, corporate frauds and other misdemeanours have eroded the market confidence. When market failures exists, regulating the financial markets will help remove market imperfections through stringent protection of property rights, reduction of conflicts of interest through regulatory surveillance and high penalties for the transgressors.

In any country, the regulatory and the institutional set-up will depend on the nature of agency problem and the type of market-based problem. In a corporate form of organisation the separation of ownership from management results in the agency problem. In UK and US the ownership of corporations are highly diffused and the management and ownership are different. In the emerging markets, corporation are majority owned and controlled by families. In India, ownership of corporations has been family controlled, without even a majority stake in the companies at the time of listing. The problem associated with such concentrated ownership is that owner/promoter's dealings are not easily controllable by internal systems (Board of Directors) and external control systems (takeover markets) and are always at the expense of the minority shareholders. In some countries cross holding of shares increases the problem against the minority shareholders. Where ownership is diffused as in the US and the UK, agency problem arises from the conflicts of interest between managers and shareholders. The agency problem in such a case would include payment of high remuneration to the managers themselves and wrong diversifications and taking excessive risk with the shareholder's funds. Countries like India and other East Asian countries have different agency problem, where the nature of agency problem shifts away from manager-shareholder conflicts to conflicts between the controlling owner and minority shareholders. The promoter owners usually have cross shareholdings and stock pyramids. These arrangements often enable the ultimate owner to command a given level of control (voting rights) while committing a less-than-equivalent ownership investment (cash flow rights). The ultimate owner in this situation could extract wealth from the firm, receive the entire benefit, but only bear a fraction of the cost. The owner can determine how much of profits are to be distributed and can opportunistically deprive minority

shareholders of their rights to share profits. Agency cost also includes allotting preferential equity allotments to promoters transferring shares through private bought out deals and ignoring minority shareholder complaints[334]. The controlling shareholders are not expected to behave in a value-destroying manner but will indulge in expropriation of minority holders' funds through subsidiary company dealings or through artificially rigging the prices in the market.[335] For these corporations and controlling owners, the cost of this agency conflict comes from their common shares being traded at discount because of the anticipated price protection.[336] Such an agency problem can hinder the growth of the capital market.

Poor transparency and governance have been stated as the major problems in emerging markets like India and other Asian countries. Since the financial crisis of 1997 and the financial frauds in the US relating to Enron Corporation and WorldCom, improving disclosures and governance mechanisms have become an important task of regulators.

In countries with strong securities markets, good disclosure and control of corporations are often presumed. United States has a complex set of laws, and various private and public institutions that have ensured adequate disclosures to reduce the information asymmetry problem and also give the investors reasonable assurance about true information. The role of institutions is quite pronounced in the US, which is the reason for a greater surprise when the Enron failure happened reflecting *a* massive regulatory failure; such failures are inherent in the regulatory process specially at detecting frauds.[337] The two sets

[334] An article in the press states that, "Indian promoters and their associates benefited by nothing less than Rs 6317.37 crore in 479 cases up to November 3, 1994 through preferential allotment of shares to themselves at a discount to the market price. M. Mehta, "Promoters Gain on the Loss of Shareholders", http://www.expressindia.com/fe/daily/19971103/30755563.html, (June 06, 2002)

[335] S. Johnson, R. La Porta, F.Lopez-de-Silanes and A. Shleifer, "Tunneling", *Working Paper No. 7523* http://www.nber.org/papers/ 2000 (June 12, 02)

[336] S.Claessens, S.Djankov, J.P.H. Fan and H.P.Lang, "Expropriation of Minority Shareholders in East Asia", Working Paper, *World Bank* (2000) refer to East Asian Countries in their paper. http://www.worldbank.org/html/dec/Publications/Workpapers/wps2000series/wps2088/wps2088-abstract.html (Feb 04, 2002)

[337] J. R. Varma, "Governance, Supervision and Market Discipline: Lessons from Enron", 14(4) *Journal of the Indian School of Political Economy* 559-632 (2002)

of problems are identified relating to the modern corporations: the problem of misstatements or inaccurate disclosures and the problem of frauds. The nature of regulation and the institutional set-up are developed based on the specific business environment and the agency problem that may occur.

The main objective of any securities regulation are i) the protection of investors ii) ensuring that markets are fair, efficient and transparent and iii) reduction of systemic risk.[338] The three objectives of regulation are achieved through anti fraud rules, merit regulations, disclosure regulations and value-based system.

Investor protection from frauds through anti-fraud rules constitutes a minimal level of regulatory protection that the law can give. These rules can operate in the form of investigation, injunction and prosecution of the violators and give a legal remedy to the investors. Some times these rules cannot adequately protect the investors, (as we have seen in India), as by that time they discover they have been defrauded, the companies and the promoters would have vanished. Civil suits would be costly and time consuming for the small investors. In a merit-based regulation, the administrative authority is vested with discretionary power to evaluate the company in terms of new issues or in the operations of the company by setting limits on various transactions. The merit regulations are based on the assumption that the regulator is better able to make decision than the market or a large body of investors. It also assumes that intervention is necessary for protection and promotion of markets. The merit-based regulations depend highly on the skill of the administrator. It may give a false impression that the securities are fully evaluated by the government in the case of new issues. Merit based regulations was quite dominant before the liberalisation process in India.

The disclosure-based regulations are based on the notion that markets are capable of taking their decision when full, fair and timely information is given. Certain transaction may not happen under the 'light' of disclosures. Along with disclosure regulations certain value-based systems are established for proper control of the companies.

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[338] See www.iosco.org (June 02, 2003)

The rule based and value based regulations are supplemented by the reputation incentives of the certain participants like the accounting firms and the investment bankers. In recent times, regulators are emphasising on the disclosure based and value systems and are moving away from the merit based system. India is moving from a merit based system to a disclosure based and value based system. In the transition phase the merit-based regulation must continue till the disclosure environment is perfected.

A number of institutions are involved in the corporate disclosure and investor protection environment. The important amongst them are:

- Standard Setting Institutions
- Enforcement systems
- Statutory Auditors
- Other Institutions

The standard setting has to be done in a transparent manner and has to keep pace with the changing business environment. A good legal enforcement mechanism also protects the investors. The statutory auditors provide credibility to the information environment. Market intermediaries like the stock exchange perform an assurance role through listing and delisitng of securities. In the following section the role of these institutions are discussed along with the concerns that led to the formation of specialised organisations. Countries like the United States and the United Kingdom already have strong markets and can offer guidance to reforms that could strengthen securities markets in other countries and also help in understanding the difficulty of creating the many institutions that support a strong securities markets. This section would be useful for policy makers for building strong institutions.

6.2 Standard Setting Institutions

Accounting Standards are set and regulated by standard setting bodies. It can be a purely political process, like in Germany and France where the accounting standards are generated by the legislative action. It could be a private and professional approach as in Australia and Canada where professional bodies set and enforce the accounting standards. The standard setting process may be a public/private or a mixed approach, where standards

are set by the private bodies but are enforced through government action or it could be a mixed approach, where accounting standards are set and enforced by accounting professionals and governmental agencies as well as industry, like in Netherlands. A constant debate that is very relevant to the Indian situation is who should set the accounting standards. Should it be the private sector or the government? Private sector institutions are perceived to be weak and do not act decisively and with authority. Researchers also perceive that when private sector sets rules it may give more flexibility and profit enhancing polices leading to less informative financial reporting. For example in the US, FASB had to abandon its proposal of eliminating the 'Pooling of Interest' method under business combinations, many a times, before it was finally eliminated. Researchers dispute the legitimacy of a private sector organisation (FASB in US) to establish public policy.[339] They express concern that the current organisational arrangements give the accountants too much control over the outcomes, resulting in an imbalance of power among affected parties. This may lead to the policies that may favour accounting profession by increasing the need for audit and accounting services without due consideration to the needs of the companies. A group of researchers feel that corporations and accounting firms may capture the accounting process, which may be detrimental to the public interest and that regulators must do the standard setting.[340] Whoever sets the accounting standards, they will be affected by both the forces of market economics and by politics. The choice of a mechanism to reconcile the two issues and how the standard setting is undertaken is an issue to be considered by the regulator. The standard setting in the USA, the UK, Germany, IAS and India are discussed in the next section.

6.2.1 Standard Setting in the USA

The earliest efforts to standardise accounting information came from the State and the Federal Government to govern monopolies of the railroads and gas utility companies. One of the earliest pronouncements came from the

[339] H. Kripke, "*Self Regulation by Accountants*" In S. A Zeff and T. F. Keller (eds), *Financial accounting Theory* 68, 66-74 (New York: McGraw-Hill Inc, 1985)

[340] Some studies concerning the FASB of the US and the concern of neutrality is focus of many studies for example: P.R. Brown, "A Descriptive Analysis of Select Input Bases of the Financial Accounting Standards Board", 19(1) *Journal of Accounting Research* 232-246 (1981)

Interstate Commerce Commission (ICC) in the year 1887. The ICC's aim was to help the regulators judge the fairness of the rates and in providing investors useful data about the financial condition and operation of the railroads. The basis of setting the standards was uniformity in reporting and accounting methods. Prior to the stock market crash the special accounting principles were developed for industries The New York Stock exchange and the accounting profession devised very few formal rules. The formal standard setting process in the United States started only after the stock market crash in 1929 and the depression after that.[341] In 1934 the Securities Exchange Act, established the Securities and Exchange Commission to formulate accounting and reporting rules for companies listed in the stock exchanges. SEC also has an objective to protect the interest of the investor by ensuring full and fair disclosures. The SEC was given specific authority to establish accounting standards for companies that went for public issue.

The centralisation of control by a government agency facilitated the enforcement of disclosures regulations. SEC initially found that there was a diversity of practices in use, making enforcement difficult. At one point of time the SEC was considering a strategy of pronouncing the accounting standards themselves. However, they decided to promote a system of participatory regulation in the private sector.[342] In 1939, a committee was formed by the name 'Committee on Accounting Procedures' (CAP), as part of the American Institute of Certified Public Accountants (AICPA), which made pronouncements in the form of Accounting Research Bulletins (ARB). These were more specific and related to problem solving rather than issuing any standards. The standard setting body, which succeeded this organisation, was the Accounting Principles Board (APB), in 1959. The APB was also set up by the AICPA. The APB made pronouncements that were called as the APB Opinions.

Both the CAP and APB had to be reorganised when issues about the standard setting process was raised by reviewers of CAP.[343] These bodies did

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[341] S. A. Zeff, "Some Junctures in The Evolution of the Process of Establishing Accounting Principles in the USA: 1917 –1972", 59(3) The *Accounting Review* 447-468 (1984)
[342] A detailed discussion in: J. Seligman, *The Transformation of Wall Street: A History of the Securities Exchange Commission and the Modern Corporate Finance* (Boston: Houghton Mifflin Co. 1982.) and W. Cooper and I. Robinson, "Who Should Formulate Accounting Principles? The Debate Within the SEC", 163(5) *Journal of Accountancy* 137-40 (1987)
[343] See Supra note 340 at 458-462

not adopt accounting principles that would help comparability and there were diverse set of accounting practices followed by companies. There was no theoretical framework to direct the selection among alternative accounting methods. Companies also did not support CAP as the standard setting body.

The APB followed a normative approach to standard setting, which to some extent reduced the diversity of practice in some areas, as companies were required to follow only the specified methods of accounting. They also used an extensive due process.[344] The APB did not complete the conceptual framework and there were considerable delays in the formulation of various accounting standards and there was great industry pressure on the Board as the independence of the APB was questioned. The increasing complexity of accounting issues and a growing demand for more sophisticated financial reporting led to the formation of the Wheat Committee set up to study the institutional processes used to establish accounting standards. This committee recommended a major restructuring of the standard setting process that resulted in the formation of the Financial Accounting Standards Board (FASB) in the US in 1973.

Financial Accounting Standards Board.

The FASB was established independent of the AICPA and its membership represents a broader set of groups.[345]The restructuring recommended by the Wheat Committee led to the FASB being structured differently than the APB. FASB has fewer members (seven as against over 20 for both the CAP and APB) and these members serve full-time (CAP and APB members retained full-time careers outside their role as standard-setters). The members are required to sever all connections with their firms or institutions prior to assuming the membership of the Board. Members are appointed for a period of 5 years. Their function is to oversee the working of the FASB. These changes were intended to help Board members identify issues pertinent to multiple

[344] Unlike the CAP, the APB distributed exposure drafts of proposed opinions and held public meetings with industry groups. Supra note 340 at 462

[345] Seats on the FASB are allocated to a broader group of constituencies, which include academics, preparers, and users of financial statements. The FASB also has adopted far more extensive due process procedures for evaluating proposed standards than the APB. See also, P. Miller and R. Redding, *The FASB: The People, The Process, And The Politics*. 31- 82 (Irwin: Illinois 1988) provide a description of the organisational structure and processes of the FASB.

constituencies, maintain independence from previous employers, and resolve disagreements. The apex body overseeing the standard setting process is the Financial Accounting Foundation (FAF) an independent institution. The members of FAF are not full time employees of the foundation. FAF oversees the activity of the standard setting Board in all matters except technical matters and they also appoint the FASB Board members. The members of the FAF are from different institutions, which fund organisations like the AICPA. The FASB-SEC relationship is that of cooperative governance of public sector and the private sector in formulating the accounting rules. The pronouncements of the FASB are treated as authoritative by the SEC. (Accounting Series Release 150) and also by the AICPA. The funding of the FASB comes from contributions and from publications.

6.2.2 Standard Setting in the UK

In the United Kingdom the standard setting process began in 1970, with the establishment of the Accounting Standards Steering Committee by the Institute of Chartered Accountants in England and Wales. In 1976, this committee was reconstituted as a joint committee of the six accountancy bodies and was known as the Accounting Standards Committee (ASC). The ASC issued accounting standards titled as 'Statements of Standard Accounting Practice' (SSAP), and Statements of Recommended Practices. SSAP covers broad accounting principles and treatments recognised and specified acceptable practices.

ASC in UK lost its credibility like their counterpart APB of the US as they were influenced by the accounting community and compromised on many issues. They also emphasised on broad principles and permitted a number of different interpretations, which lead to alternative treatments. The ASC was very slow to respond to changes in the financial reporting environment, because it needed to secure the agreement of six accounting institutes and because it lacked necessary resources. These factors coupled with increasing complexity of accounting issues led to the formation of a new standard setting body. The Financial Reporting Council (FRC) replaced the ASC in the UK.

Financial Reporting Council

The Financial Reporting Council in UK was established with the objective of promoting good financial reporting. FRC oversees two other organisations: the

Accounting Standards Board (ASB) and the Financial Reporting Review Panel (FRRP). The Chairman, three Deputy Chairmen and up to thirty members manage the FRC. Secretary of State for Trade and Industry and the Governor of the Bank of England acting jointly appoint the Chairman and Deputy Chairman. The FRC members include representatives from the city at the highest level, including members of the accountancy and legal profession, chairman and senior Directors from a wide spectrum of large and smaller companies, and senior officials from Government and the public sector. The FRC provides general policy guidance to its operational bodies, the ASB and the FRRP.[346] The Council is required to publish a report annually reviewing the state of financial reporting and giving the Council's general views on accounting standards and practices. The present scope of FRC has been enhanced to include five subsidiary Boards including the three new additions of the Auditing Practices Board, the Accountancy Investigation and Discipline Board and the Professional Oversight Board (Accountancy), which will encompass the Audit Inspection Unit. The functions of FRC have been enlarged to take active role in relation to corporate governance also. FRC seeks a proactive role in relation to compliance with company law and accounting standards and it assumes new responsibilities in relation to audit, auditing standards and the oversight of the self-regulatory professional bodies.

The ASB in UK has up to ten Board members, with a Chairman and the Technical Director who are full-time, and the others representing a variety of interests who are part-time. Board members are appointed by an Appointment Committee, which has the Chairman, and Deputy Chairman of the Financial Reporting Council (FRC) along with three members of the Council. Three observers also attend the ASB meetings. The ASB makes, amends and withdraws accounting standards. Under the ASB's constitution, votes of seven Board members (six when there are fewer than ten members) are required for any decision to adopt, revise or withdraw an accounting standard. FRC has a strong support of government, it is not government controlled, rather it works as a part of the private sector process of self-regulation. The FRC and their subsidiaries are supported and funded jointly by the accountancy profession

[346] From the Financial Reporting Council website: www frc.org.uk/ (June 30, 02)

(through the Consultative Committee of Accountancy Bodies), the London Stock Exchange and the banking and investment community.

6.2.3 Standard Setting in Germany

In Germany, until 1998 there was no separate standard setting body. Accounting principles were prescribed in the GoB. In 1998, due to increased pressure of international harmonisation, the 'Law on Control and Transparency in Business' was enacted. This law created pre-conditions for recognition of a privately organised accounting standards committee.

The German Accounting Standards Committee (GASC or the DRSC) was formed in 1998 with objectives: (i) to develop accounting standards for application in the area of consolidated financial reporting (not for individual company financial reporting); (ii) to represent German interests on international committees; liaison with international standard setters and (iii) to act in a consultative role in relation to the development of accounting legislation. The standards are approved by German Ministry of Justice and are published in the Federal Gazette.

6.2.4 International Accounting Standards Board

The growth of international trade and the issue of accounting diversity initiated an agreement among Canada, the UK and the United States in 1966 to create a study group to organise a program of comparative studies of current trends in accounting thoughts and practices in the three countries which led to the formation of the Accountants International Study Group (AISG) in 1967. When the AISG met at the Tenth International Congress of Accountants in Sydney, Australia, in 1972, it decided to form an international accounting body. This new body was the IASC, with Lord Benson as its first chairman. The IASC founding members consisted of 16 professional accounting organisations from nine countries: Australia, Canada, Germany, France, Japan, Mexico, Netherlands, United Kingdom and United States. IASC is the only private standard setter in the international environment.

IASC utilised private and public sector expertise and provided for broad inputs into the standard setting process from many countries, involving standard setting bodies, auditors and users of financial statements as well as

regulators.[347] The IASC was reconstituted as a trust in the year 2001. The standard setting body at present is the International Accounting Standards Board (IASB). The members of the IASB are appointed by the trustees and comprise of twelve full-time and two part time members. The IASB comprises of, The International Financial Reporting Interpretations Committee, (IFRIC) that prepares the Interpretations of IFRS and the Standards Advisory Council (SAC) that provides a formal vehicle for participation by organisations with an objective of giving advice to the IASB on priorities and on major standard setting projects.[348] The new Board has the right to make new standards called as the International Financial Reporting Standards (IFRS) and withdraw the earlier ones, till then the IAS continues to operate.

Approval of International Financial Reporting Standards (IFRS) and related documents, such as the 'Framework for the Preparation and Presentation of Financial Statements', Exposure Drafts, and other discussion documents are part of the IASB.

Many companies/countries have voluntarily adopted the International accounting standards. The IASB is considering the revision of at least eleven accounting standards in the near future.[349] Amongst the power struggle to set global accounting standards is the FASB. The standard setting process by these organisations are discussed in the next section.

6.2.5 Standard Setting in India

As against the independent standard setting bodies in UK and USA the standard setting body is part of the Institute of Chartered Accountants of India (ICAI). The ICAI constituted the Accounting Standards Board (ASBI) in 1977, with a view to harmonise the diverse accounting policies and practices. The main function of the ASBI is to formulate the Accounting Standards. While formulating the Accounting Standards, ASBI gives due consideration to the International Accounting Standards issued by the IASB and tries to integrate them, to the extent possible, in the light of applicable laws, customs, usages and

[347] Although United States was a founder member of the IASC, they still chose to promulgate their own accounting standards.
[348] www. iasb.org.UK/docs/preface/ed-preface.pdf(June 03,03)
[349] IASB, Project Summary: Improvements to IASB Standards from www.iasb.org. (Feb 01, 03)

business environment prevailing in India. The ASBI also issues Guidance Notes and gives clarifications on issues arising from the accounting standards. The ASBI comprises of representatives from different groups. There are members nominated from the Department of Company Affairs, Educational institutions, and representation from tax authorities, Comptroller and Auditor General of India, Financial Institutions, other Professional Institutes and others. The Companies Act under Section 211 has constituted an advisory committee called The National Advisory Committee on Accounting Standards (NACAS). This committee will advice the Government on the formulation of Accounting Standards and Policies and laying down accounting policies and standards for adoption by companies. This committee can also give its recommendations on the accounting policies and standards, from time to time, to the Central Government

6.2.6 Standard Setting Process

An effective standard setting regime should be based on the ability of the standard setting body to fulfil its functions. An important aspect of the standard setting is not whether the regulator or the private body should set the standards, rather it is a question of how the standards should be set. The accounting standard setting process is as important as the standard setter and the standards themselves. The accounting standard setting process must be fair and operate in an open environment. High quality standards are a necessary pre-requisite of high-quality financial reports. Some of the qualities a good standard setter should possess are: [350]

- The standard setter should address accounting issues brought to their attention by external parties (users, preparers, regulators, and the general public, including academics) in a responsive and timely manner.
- The standard setter should actively seek communication with external experts about the accounting problems and all relevant accounting alternatives on his agenda, for example, through meetings, public hearings, invitations to comment on discussion papers, and field hearings an open and transparent process of setting the standards.

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[350] FASB, International Accounting Standard-Setting: A Vision for the Future *(FASB Report,* 1998) www.fasb.org (Nov 2, 02)

- The standard setters should publish exposure drafts of proposed rules together with an outline of the basis of conclusions and ask for comments from all interested parties within a reasonably long comment period.
- The standard setter should consider all comments carefully in redrafting proposed rules or issuing final standards.
- The decisions on issuing exposure drafts or final standards should be taken in meetings open to the public that give dissenting opinions the chance to be heard. If necessary, the standard setter should support the implementation of standards by providing guidance like giving illustrative examples and conducting training courses.
- The standard setter should evaluate the success of the standard with regard to the objectives.

The Accounting Standards Board in UK, FASB and IASB has elaborate procedure for issuing the accounting standards. The UK ASB's policy is to consult widely on all its proposals. Generally the development of a new accounting standard involves at least two formal consultation documents, a Discussion paper and a Financial Reporting Exposure Draft.

FASB follows a rigorous due process. Various issues are identified and the Technical Advisory Staff invites public debate on the proposed standards. If the issues are significant then a task force is appointed. FASB research and technical staff will research the issue and at least a majority of seven members must vote to adopt an issue. A discussion memorandum is issued after which a public hearing is held after sixty days. The Exposure draft is then issued so that interested persons can make additional comments. The minimum exposure period is 30 days. These comments are evaluated by FASB, modified if necessary and then put to vote. The members vote on the various proposals and at least five members out of seven have to approve it. Reasons for adopting or not adopting are explained in the accounting standards themselves. These ensure an open and transparent standard setting process.

The IASB also adheres to an elaborate process while formulating the accounting standards. At the early stages of a project an Advisory Committee is likely to be set up to give advice on the issues arising in the project. Consultation with the Advisory Committee and the Standards Advisory Council occurs through

the project. The discussion documents are then published for public comments. Based on the feedback the 'Exposure Drafts' are prepared and published for comments once again. The publication of an exposure draft, accounting standards and its interpretation require an approval by eight of the fourteen members of the IASB. Other decisions of the IASB, including the publication of a draft statement of principles or discussion paper, shall require a simple majority of the members of the IASB present at a meeting that is attended by at least 60% of the members. The agenda for each meeting of IASB, Standards Advisory Council (SAC) and the Standing Interpretations Committee (SIC) is published in advance and the Secretariat publishes a summary of the technical decisions made at such meetings promptly thereafter. The exposure drafts and similar documents are available for comments for a period of ninety days. In exceptional circumstances proposals may be issued with a comment period of sixty days. Various comments received are posted on the website of the IASB.

Meetings of IASB, SAC and SIC are open to public observation. When IASB publishes a Standard, it also publishes a basis for conclusions to explain publicly how it reached its conclusions and to give background information that may help users of the standards to apply them in practice. IASB also publish dissenting opinions.

Other limbs of FASB and the ASB are the Urgent Issues Task Force (UITF) and the Standards Interpretation Committee (SIC.) In the UK the UITF assists the ASB in areas where an accounting standard or Companies Act provision exists, but where unsatisfactory or conflicting interpretations develop. The UITF then seeks consensus on the accounting treatment that should be adopted. Such a consensus is reached against the background of the ASB's declared objectives and principles. The ASB normally accepts the UITF's consensus, subject only to the ASB's overriding duty to ensure that there are no conflicts with the law, accounting standards, or the ASB's policies.[351] The results of the UITF's deliberations on a subject are promulgated by means of published abstracts. Other publications that are advisory in nature are the Discussion papers, Working and Progress Papers and Newsletters in UK.

[351] www.asb.org.uk/uitf/index.html(Oct 11, 2003)

In Germany the source of interpretation and guidance is the pronouncements issued by the IDW, which are to some extent similar in nature to standards and interpretations issued by the ASB and the UITF in the UK. The IDW and its main technical committee develop interpretation guidance. It is issued in the form of statements of the IDW.

As part of the ongoing efforts to move German accounting and auditing principles closer to the internationally accepted practice, the IDW has started to revise its statements on accounting and auditing renaming them as IDW PS or the Auditing standards and the IDW RS or the Accounting Standards. Commentaries on various issues are important although legally they are not binding, but are considered good practices. In India there are no UITF or the SIC but the Board itself has now started issuing clarifications called as 'General Clarifications' and 'Accounting Standards Interpretation'.

The procedure for formulating and issuing accounting standards is determined by the ASB in India. In the preparation of Accounting Standards, ASB is assisted by study groups, constituted by the members of the Institute, for considering specific subjects. At present there are 12 members on the Board with a Technical Director. The Board holds a dialogue with the representatives of the Government, Public Sector Undertakings, industry and other organisations for ascertaining their views. On the basis of the work of the Study Group and the dialogues with the organisations referred above, an exposure draft of the proposed standard is prepared and issued for comments of the members and public at large. ICAI publishes the exposure draft in its Journal and also sends to various organisations like Reserve Bank of India, Central Board of Direct Taxes, Confederation of Indian Industries and others for their comments. Comments received are then collated for consideration. However, there are no public discussions or debates except through the comments received. The various comments received are not made public. ASB finalises the draft of the proposed Standard, on the basis of comments so received and submits the same to the Council of the Institute. The Council considers the final draft of the proposed standard and, if necessary, modifies the same in consultation with the ASB. Thereafter, the accounting standard is issued under the authority of the Council. Similar process is followed for any limited revision of the accounting standards.

An observed difference between the US, the UK systems and the Indian System is the process of issuing the accounting standards. Accounting standards are an instrument of public policy; therefore a broad public debate is warranted with inputs from the governments, regulators, professional associations as well as the users and the preparers. A public debate on the proposed standards and a transparent process with respect to publishing the comments received on the proposals and the deliberations that go on in the process while finalising the accounting standards is not apparent in the process of standard setting. The process should also include the reason for accepting or rejecting an accounting alternative. Some authors on the subject feel that the Indian Accounting standards reflect the view of auditors and are not stringent enough. There is widespread non-compliance in the accounting standards and lack of stringent enforcement. The ASB issued 15 Accounting standards over a period from 1977 to 1998 (21 years). However in the last few years' additional 14 standards have been issued. In all there are 29 Accounting standards issued at the end of 2003. Some of the new accounting standards are the verbatim reproduction of the IAS. A reason for the lack of development could be that accounting standards for a long time had no legal backing and were only recommendatory in nature. In 1991, eight accounting standards became mandatory, and the auditors reported any departure from the accounting standards. Until recently there was no authority for the Institute of Chartered Accountants to insist on compliance of the AS. They were only recommendatory in nature. The Companies Amendment Act, 1999 inserted a new clause in Section 211. Section 211 (3A), requires that every profit and loss account and the balance sheet must comply with the accounting standards. Further those standards recommended by the Institute of Chartered accountants of India and which are prescribed by the National Advisory Committee (Section 210 A of the Act) have to be followed. The Companies Act also gives a caveat that accounting standards issued by the ASB will be followed until the accounting standards prescribed by Central Government are in place.

While the standards are being set by the ASB there are many areas in the AS which need clarifications which were discussed in Chapters 3 and 4. An example is the AS 22 on the deferred tax, which came into effect on 1/4/2001.

Companies have disclosed the Deferred tax liability/asset in various places. (The Schedule VI itself has no deferred tax as a heading, but allows limited flexibility to have new items) Companies presented the deferred tax liability i) after unsecured loans ii) under the asset side after the net current asset as a negative figure. The Deferred tax asset is shown as an item i) after the net Current asset ii) after the investments head.[352]

Differences are observed in the applicability of the accounting standards. In India accounting standards are applicable to all the companies that are registered under the Companies Act [353] while in the US the accounting standards are applicable to only listed companies. In the UK, the accounting standards are exempt for small and medium enterprises.

To conclude, the accounting standard setting process in India must be brought in line with FASB and IAS. The IASB has issued an elaborate due process for national standard setters who will follow the same in their countries before the IAS is adopted in the respective countries so that they would integrate with IASB's due process.[354] This integration would avoid unnecessary delays in completing standards and would also minimise the likelihood of unnecessary differences between the resulting standards. The setting up of the National Advisory Committee under the Companies Act, hopes to bring about changes in the due process of the standard setting in India.

While there are standards for financial numbers it is recommended that guidelines and standards be provided for non-financial information without affecting the companies own initiative on voluntary disclosures.

6.3 Enforcement Systems

In the absence of perfect competition in the securities market, the role of regulator becomes extremely important. The regulator ensures that the market participants behave in a desired manner so that securities market continue to be a major source of finance for companies, at the same time the interest of investors are protected. As Ball puts it, "the accounting infrastructure

[352] Such confusions could have been avoided with a clarification were given earlier. The Accounting standards interpretation (ASI) - 7 [352] was issued on 14th October 2003 clarifying this.
[353] The ICAI has recently given an exemption from some standards for certain businesses.

complements the overall economic, legal and political infrastructure in all countries."[355] Investor protection enhances investor confidence and contributes to the market growth. Such protection is best understood as a combination of different, but closely integrated measures - including, but not limited to, market regulation & enforcement, trading and settlement system reliability, information disclosure and equal accessibility. The regulator should have comprehensive enforcement powers and the regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program. Disclosure regulations and regulations relating to frauds are two areas where authorities enforce regulations for investor protection.

The enforcement of disclosures regulations is as important as the setting of the standards themselves. Even if harmonisation of accounting principles occurs, enforcement may not exist at all or may vary significantly between countries, which will affect the efficient functioning of the capital markets. Many scholars argue that the extent to which standards are enforced and violators prosecuted are as important as the standards themselves.[356] In particular, the quality of financial information is a function of both the quality of accounting standards and the regulatory enforcement or corporate application of the standards. In the absence of proper enforcement, even the best accounting standards will be inconsequential. If nobody takes action when rules are breached, the rules remain requirements only on paper. With no penal consequences, some firms may not follow the mandatory requirements. For example, the disclosures of accounting policy are required in most countries as well as by International Accounting Standards. There is however, a considerable variation in accounting policy disclosures within and across countries.[357] Measuring the enforcement regulations across countries is difficult. The difficulty

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[354] Due process given in www.iasb.org/about/due_process.asp (Dec 08, 03)
[355] See Ball et al Supra note 113 at 128
[356] S. Sunder, *Theory of Accounting and Control* 172 (Cincinnati: South Western College Publishing, 1997)
[357] S.M. Saudagaran and J.G. Diga, "Financial Reporting In Emerging Capital Markets: Characteristics And Policy Issues", 11(2) *Accounting Horizons* 41-64 (1997) also see C.A. Frost and K.P. Ramin, "Corporate Financial Disclosure: A Global Assessment", in *International Accounting and Finance Handbook* (F.D.S Choi, ed., New York: John Wiley and Sons, 1997)

in measuring enforcement arises in part because enforcement takes different forms in different countries.

While fraudulent reporting is serious, frauds perpetuated against minority shareholders is a more serious offence that will drive away the investors from the capital market. If markets have to function effectively then reforms have to take place in the following areas; 1) Oversight of Disclosure Regulations 2) Legal Systems and 3) Statutory Audits. The discussion on these follows.

6.3.1 Oversight of Disclosure Regulations

While standards are set for reporting and measurement, it is very important to ensure compliance of the standards set. Companies have sufficient flexibility in reporting and in selection of the accounting policy. Management may follow aggressive financial accounting policies, may not report adequately or even give false information, which may affect the true and fair view of the financial statements. This is termed as "Fraudulent Financial Reporting (FFR)." In the US the National commission of Fraudulent Financial Reporting also called the Treadway Commission defined 'Fraudulent Reporting' as "intentional or reckless misconduct, whether act or omission, that results in a materially misleading financial statements".[358] If financial reporting is not correct, it will be costly for the investors, creditors, analysts, customers and other parties who rely on these misleading financial statements.

The Auditing Assurance Standards-4 recognises mis-statements in the financial statements arising out of errors and out of frauds. Errors occur due to incorrect estimates arising out of oversight or misrepresentation of facts or mistakes while processing the data or in the application of accounting principles. Fraudulent reporting can involve many factors and take many forms. It may entail gross and deliberate distortion/falsification or alteration of corporate records. It may involve deliberate omission of facts or events from the financial statements. It may entail intentional misapplication of accounting principles. Any intentional and reckless behaviour, also resulting in fraudulent statements would be treated as fraudulent reporting. Any attempt to hide any frauds or any

[358] Fraudulent Financial Reporting: 1987-1997 - An Analysis of U.S. Public Companies Executive Summary and Introduction" http://www.coso.org/publications/executive_summary_fraudulent_financial_reporting.htm (Nov 3, 02)

reporting that misleads or hides the true financial position of the company will be deemed as Fraudulent Financial Reporting. To qualify as a FFR the most important requirement is it has to be intentional or deliberate concealment of facts. Usually, FFR occurs when management want to meet investors expectations or to show a better picture when they are facing financial difficulties or if the managerial remuneration is based on the performance of the company or may be deliberate acts. Many factors present an opportunity for false reporting. These factors included weak internal control, ineffective internal audits and presence of subjective accounting estimates and the absence of regulatory oversight.

Frauds

"The body of small investors must have adequate confidence in the market, directly or even better through the mutual funds. One important element of this faith is the ability of the regulator to quickly investigate frauds and punish the guilty." [359]

The Auditing and Assurance Standards 4, defines fraud as, 'intentional act by one or more individuals among management, employees or third parties who by deception obtain illegal or unjust advantage'. The frauds committed on account of misappropriation of assets is an equally serious offence. The Statement on Auditing Standards (SAS) No. 82, Consideration of Fraud in a Financial Statement Audit, distinguishes fraud from error on the basis of whether the underlying action that results in a misstatement of the financial statements is intentional or unintentional. Misappropriation of assets (sometimes referred to as defalcation) involves the theft of an entity's assets, accompanied by financial statement misrepresentation. Misappropriation of assets can be accomplished in various ways, including embezzling receipts, stealing assets or causing an entity to pay for goods or services not received. Misappropriation of assets may involve one or more individuals among management, employees or third parties. Fraud also may be concealed through collusion among promoters/management and their associates, employees or third parties.

Fraudulent financial reporting and frauds have to be monitored and the perpetrators should be punished. Financial Reporting Review Panel, SEC and

[359] Report of the Committee on Corporate Audit and Governance at http://www.sebi.gov. at Para 5.14 referred herein after as the Naresh Chandra Committee report.

ROC and SEBI are the regulatory institutions that monitor the companies. In the next section the monitoring role of these institutions are discussed.

United Kingdom

In United Kingdom, the institution responsible for monitoring financial reporting quality through the enforcement of accounting standards is the Financial Reporting Review Panel (FRRP) and the Department of Trade and Industry (DTI). The DTI focuses on small and medium listed companies while the FRRP focuses on large listed companies. The DTI has the power to investigate companies for fraud and misconduct or where shareholders have been denied reasonable information or in the interest of the public. The FRRP is responsible for reviewing apparent departures from the accounting requirements of the Companies Act and forcing remedial action where the financial statements in question are deemed to be defective. The FRRP is perceived to have had a positive impact on the quality of financial reporting in the UK since it began operations in 1991.[360] The FRRP began operations in mid 1991 as part of a fundamentally restructured accounting standards-setting system. The FRRP is an enforcement authority whose role is to examine material departures from the accounting requirements of the Companies Act 1985 and applicable accounting standards. Its jurisdiction is restricted to companies' annual reports and its remit encompasses all public limited and large private companies (That is, all firms that do not qualify as small or medium-sized enterprises under section 247 of the Companies Act 1985).

FRRP adopts a reactive approach to the detection of defective financial reporting. It does not scrutinise all company reports falling within its scope but only when certain signals are sent. The three primary sources of investigation are: i) a qualified audit report or disclosed non compliance with accounting standards or other requirements ii) referral by an individual or a corporate body, and iii) press comments.[361] The FRRP never reveals the identity of the complainant, or in what context the complaint was made. If under investigation

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[360] S. Fearnly, A. Hines, K. Mcbride, and R. Brandt, "A Peculiarly British Institution: An Analysis of the Contribution made by the Financial Reporting Review Panel to Accounting Compliance in U.K.", 3 (London: ICAEW, 1999)
[361] The functions and role of FRRC was drawn for the website http://www.frrc.org

FRRP finds that the accounting treatment under investigation is not justified and does not provide a true and fair view, then remedial action is sought. This usually takes the form of either a revision or retrospective restatement of the published figures. In attempting to resolve cases requiring remedial action, the FRRP first seeks to persuade the firm in question to voluntarily accept the decision and institute the required corrective action. Failing that, the FRRP has the power to apply to the court for an order requiring the financial statements to be restated. If the court upholds such a request, all legal costs, together with any reasonable expenses incurred by the firm in revising its accounts, must be borne by the Directors who approved the defective statements (UK Companies Act 1989, Sec 245B). When the case is concluded out of the court, it issues a public statement providing details of the case and the method of resolution. The public statements play an important role by providing information and guidance on flawed accounting treatments, which deters other companies.[362] FRRP identification of firms for investigation is similar to the approach adopted in the USA by the SEC. However, the FRRP has less resource than the SEC and relies more on signalling process. In India there is no such comparable organisation.

The listing regulation is formulated by the UK listing authority. Prior to this the listing regulations were formulated by the London Stock exchange. The new listing authority comes under the Department of treasury. The listing authority has the power to punish the Directors and others for market abuses such as insider trading.

The enforcement of fraud related offences in the UK is done through the Serious Frauds Office. The Serious Fraud Office (SFO) is an independent government department that investigates and prosecutes serious frauds. The SFO is a part of the UK criminal justice system. The Director is appointed by and accountable to the Attorney General who heads the organisation. SFO investigates a case when referred, and if there is reasonable grounds to believe that serious or complex frauds have been committed. The key criterion for deciding this is monetary or the money involved in a fraud. The SFO does not investigate or prosecute cases involving less than £1 million.

[362] D. McBarnet and C. Whelan, *Creative Accounting and the Cross-Eyed Javelin Thrower*, 66 (Chichester: John Wiley & Sons 1999)

Once the case is investigated, criminal proceedings are started if a realistic prospect of securing a conviction is present and it is in the public interest.

Untied States of America

The Securities Act of 1933 and 1934 acknowledged that financial accounting and reporting were matter of public interest and that the government had right to regulate the corporate disclosure practices. The objective of the regulators were full and fair disclosures of the relevant financial information for the investors that would be regulated by an independent regulatory agency that would promulgate accounting and reporting standards for companies whose shares were listed on the stock exchanges. The need for a control mechanism lead to the establishment of the Securities Exchange Commission (SEC) in the United States. The objective of the SEC is "to protect investors in securities markets that operate fairly and to ensure that investors have access to disclosure of all material information concerning publicly traded securities... also regulates firms engaged in the purchase or sale of securities, people who provide investment advice, and investment companies."[363] The SEC not only looks into the standard setting but also monitors the financial reporting of listed companies. Listed companies have to file their audited financial statements with the SEC and as full and fair disclosure is the aim of the Securities law in the US, the Securities Act prohibit the companies from giving misleading or fraudulent financial statements.

Section 12 of the Securities Act, gives SEC wide powers of enforcement for violation of the Securities Act through 1) Informal investigations 2) Formal Investigation 2) Disciplinary hearings 4) Injunctions, 5) Stop order proceedings and 6) References and action for criminal prosecution.[364] Each year the SEC brings between 400-500 civil enforcement actions against individuals and companies that break the securities laws. Typical infractions include insider trading, accounting fraud, and providing false or misleading information about securities and the companies that issue them. This also includes information

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[363] http://www.sec.gov

[364] G. Spellmire, W. Baliga and D. Winiarski, "SEC Enforcement Actions", *Accounting Auditing and Financial Malpractices"* 248 (New York: Harcourt Brace and Company 1998): Injunctions are available if the case is taken to the court

released through the Internet. SEC widely publishes its enforcement actions as a form of sanction against people who violate the rules.[365] The rules also allow the suspension or bar permanently from practice any person who aids and abets the violation of Securities Law.[366]This rule can also be evoked against the auditors and attorneys. The number of fraud related enforcement actions by the SEC indicate a high incidence of fraudulent financial reporting and is a continuing problem. The certification of a financial statement that is in violation of GAAP also initiates action by the SEC. When securities were misclassified and property not owned were also shown in the financial statements, the court held that there was a violation of GAAP provisions and there was improper professional conduct and imposed sanctions on the accountant.[367]

The enforcement division of SEC routinely investigates disclosures by public companies. Since the collapse of Enron, the SEC Division of Enforcement has intensified its focus on accounting and other disclosures by public companies. There are many reasons why the SEC might begin an investigation. The SEC conducts surveillance activities with respect to the stock market and the Internet, and reviews news stories in the media. The Staff obtains referrals from other divisions, other government agencies, and from self-regulatory organisations such as the National Association of Securities Dealers, Inc. (the "NASD") and the New York Stock Exchange (the "NYSE"). They also receive communications, often via the Internet, from investors, employees and others.[368] The purpose of an informal investigations is to gather enough evidence to determine whether to i) conduct a formal investigation or disciplinary hearing, ii) seek a civil injunction in a US district court, or iii) refer the matter to the criminal authorities. The purpose of the formal investigation is to gather evidence that is not available at the informal stage for a disciplinary action or for injunction.

Rule 8(a) of the SEC Rules of Practice permits the SEC to agree to offers of settlement submitted on behalf of an accountant. The certification of financial

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[365] An example of financial reporting fraud published by SEC can be found in the website http://www.sec.gov/news/extra/finfrds.htm

[366] See Sec 12 of the Securities Act, 1934 and Rule 2(e) the broad power of enforcement over violators and the penalties.

[367] Davy v SEC AAER No. 53, CCH 73,453 (1985) affd, 792 F.2d 1418 (1986) as quoted in supra note 363 at 261

statements that are false and misleading may be the basis for denying an accountant to practice as an auditor. This type of conduct involves the certification of financial statements that an auditor affirms are in conformity with GAAP or SEC reporting requirements that, in fact, do not conform with those requirements. For example in Davy v. SEC, a CPA was disciplined in part for violations of GAAP.[369]The auditors certified financial statements that included real estate holdings that were not owned by the audited corporation. Additionally, the statements misclassified securities transactions as the purchase and sale of goods. The financial statements of the corporation reflected the unowned property and misclassifications. The court found that the inclusion of un-owned property in the financial statements and the misclassified securities transactions in the presentation of the financial statements were in violation of GAAP and that the accountant was guilty of a wholesale abdication of his responsibilities. In addition, the court held that this conduct constituted improper professional conduct and imposed sanctions on the accountant.

The Sarbanes Oxley Act, 2002 saw the establishing of 'The Public Company Accounting Oversight Board' (PCAOB) as an independent (non-federal) non-profit corporation, to oversee the audit of public companies that have to comply with the securities laws and related matters. Their objective is also to protect the interests of investors and further the public interest in the preparation of informative, accurate, and independent audit reports for listed companies. The objective of the Board is to oversee the audit of public companies, establish audit report standards and rules, inspect, investigate and enforce compliance on the part of registered public accounting firms and those associated with the firms.

A feature of the enforcement system is the procedure for restatement of earning numbers by companies The restatement of earnings by companies have increased over the last few years. These restatements are not a recalibration of investors' expectations but rather a change in results previously announced by

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[368] FFR in the US involves millions of dollars after which many of the companies filed for bankruptcy and liquidation. In many cases the auditors were also found liable for not uncovering the scheme.

[369] The auditor was also disciplined for the wholesale abdication of professional responsibility, Supra note 364 AAER No. 53, at 63 and 195

companies to be the 'real numbers'.[370] The accounting issues such as errors/ irregularities/method changes; SEC initiated; acknowledged fraud; earnings/loss arrangement; restructuring/spin-off; legal settlement; merger/joint venture; stock split/dividend; triggers restatements by companies.

India

In India the Registrar of Companies (under the Department of Company Affairs (DCA)) and Securities Exchange Board of India (SEBI) in certain areas oversee the functioning of the corporate sector.

SEBI was established by an enactment in 1992, as an independent capital market regulating authority with the objective to protect the interest of the investors in securities and to promote and regulate the securities market. The abolishing of the Controller of capital Issues and the stock market scam initiated the establishment of SEBI. The SEBI Act, 1992 was enacted to empower SEBI with statutory powers for (a) protecting the interests of investors in securities, (b) promoting the development of the securities market, and (c) regulating the securities market. Its regulatory jurisdiction extends over companies in the issuance of capital and transfer of securities, in addition to all intermediaries and persons associated with securities market. It can conduct enquiries, audits and inspection of all concerned and adjudicate offences under the Act. It has powers to register and regulate all market intermediaries and to penalise them in case of violations of the provisions of the Act, Rules and Regulations made there under. SEBI has full autonomy and authority to regulate and develop an orderly securities market.

SEBI's has developed a 'Strategic Action Plan' in the key spheres of:

- Enabling the investors to make informed choices and decisions and achieve fair deals in their financial dealings. Regulate firms and their senior management in a way they understand and meet their regulatory obligations.
- -Establish confidence in the participants about efficient, orderly and clean markets.

SEBI has achieved considerable progress in the reforms of the securities market, particularly in the establishment of market-determined allocation of

[370] T. DeMel, "All Earnings Restatements are Not Created Equal", 5(3) http://www.cba.gsu.edu

resources, screen-based nation-wide trading, dematerialisation and electronic transfer of securities, rolling settlement, sophisticated risk management and derivatives trading, and an improved regulatory framework and efficiency of trading and settlement.

SEBI has also directed the stock exchanges to include many of the recommendations in the Kumaramangalam Birla Committee Report in the listed company's report to improve the disclosures as well as governance of the companies. However, in terms of scrutinising the financial reporting SEBI has not advanced much. The US has an integrated approach to the securities market with SEC as the overseeing body for all listed companies. The integrated approach would mean that all documents are filed centrally including the annual report and other reports in the Edgar Data Base.

Various documents specified in the Companies Act are filed with the ROC, which is under the Department of Company affairs. Although the ROC has the power to scrutinise the financial statements, it ha is used in a very limited way. As discussed in the Naresh Chandra Committee Report, the ROC offices do not have enough capacity and are ill equipped to handle the number of companies. The number of documents filed has risen from 28500 to 28,00,000 over the last two decades and only a *pro-forma* scrutiny is done.[371] The number of companies have also increased manifold as a result of which ROC's resources are not enough for adequate enforcement. The Naresh Chandra Committee has also proposed a random scrutiny of accounts of companies. The ROC and SEBI infrastructure must be strengthened to carry out investigation related to financial reporting and enforcement of other sections of the Act. A fee based system for review of the financial reporting could be adopted by the ROC. A reasonable fee could be charged from the applicant for review. Stringent criteria can be imposed for initiating the review so it is not misused.[372]

The existence of two bodies has caused an overlapping of functions, especially when dealing with investigation related to listed companies. As observed in the Naresh Chandra Committee Report (at 5.03) "neither the DCA

/magazine /fall2002/ earnings.html (May 05, 2002)

[371] The Report of the Committee on Corporate audit and Governance referred as Naresh Chandra Committee Report at 5.40 website: www.sebi.gov/(Nov 12, 03)

[372] See J. R. Varma, Supra note 337 at 559 -632

nor SEBI was able to take effective action in providing relief to the investors or punishing the perpetrators." The lack of concerted action against the vanishing companies was cited as another example to prove the point. Some of the recommendation of the Naresh Chandra Committee is given in Appendix 12.

The ICAI has recently formed a committee called as" Financial Reporting Review Board".[373] This Board will commence a formal review of the financial statements. It is recommended that such review must be backed with a stringent action against the defaulters.

The DCA has set up the Serious Fraud Investigation Office (SFIO), an agency set up for investigating serious corporate frauds. The SFIO has been set up to take up investigation of complex frauds having inter-departmental and multi-disciplinary ramifications, besides the public interest in terms of monetary misappropriation or in terms of the number of persons affected. This multi-disciplinary team (14 members) comprises experts in the fields of accountancy, auditing, law, information technology, taxation, capital market and media management. Whenever necessary, it may also outsource investigations to professional agencies. At present DCA takes only those cases, which are not under investigations by any other body. A separate legislation is required for dealing with complex investigations. An online form for complaint by public is also provided in the website. It is recommended that when the investigations are complete legal action be initiated and publish the same. The speed is the essence of all investigations that must ultimately lead to legal consequences.

The concern about the fraudulent financial reporting and dubious practices is a cause of concern of legislative and regulatory body. The legal system consisting of law and its enforcement is important for the efficient functioning of the market by bringing to justice the wrong doers and also providing relief to the victims.

6.3.2 Legal systems

The integrity of financial reporting and other questionable practices leading to business failure is a cause of great concern of legislators and regulators. Legal remedies in such cases holds the key in providing succour to

the investor and also acting as a deterrent to the perpetrators. At the same time legal solutions are not always possible. The regulators in such a case try and establish good governance structures that will independently oversee the management.

When investors provide finance to a company, they get certain rights that are usually protected through the legal system. These rights relate to protection of minority shareholders, voting rights for important corporate matters, ensuring that the owner managers perform their duty to the shareholders, preventing self-dealings and protecting creditors. It also includes power to change the Directors, sue the Directors and get compensation and ultimately windup the company if the situation so warrants. In terms of disclosures, an investor has the right to get true and fair information based on which he takes his decision. The laws and their enforcement through the courts are essential elements of corporate governance and finance.

Recognising the role and importance of the legal system Jensen and Meckling observes:

> "Statutory law sets bounds on the kinds of contracts into which individuals and organisations may enter without risking criminal prosecution. The police powers of the state are available and used to enforce performance of contracts or to enforce collection of damages for non-performance, The courts adjudicated contracts between contracting parties and establish precedents which form the body of common law." [374]

The legal environment ensures the investors confidence through the establishment of market integrity where the investor can do business without being defrauded. It also ensures that corporate insiders do not take advantage of the situation to exploit the minority, based on the asymmetry of information. The market integrity presupposes the elimination or a reduction of activities such as insider trading.

A component of legal environment is the judicial efficiency. This measures the "efficiency and integrity of the legal environment as it affects business."[375] A country's judicial system might be functioning well but enforcement of accounting regulations may be lacking. The reverse case of having an efficient enforcement

[373] www.icai.org under committees
[374] Jensen and Meckling, Supra note 86 at 311
[375] La Porta et al Supra note 9 at 1124

of accounting standards but a weak judicial system has not been observed. A good judicial system that can handle complex securities cases and also intervene quickly when needed to prevent the misappropriation of funds or assets stripping by parties is an important requirement for the proper functioning of the securities market. In this respect the law must be quickly able to freeze the assets of the persons committing frauds.[376] A factor of enforcement is the rule of law. The rule of law assesses a country's law and order tradition. If a legal system cannot penalise in a meaningful way it risks being marginalised.

The proper functioning of the legal system is therefore very important to protect the minority shareholders. If enough legal protection is not there, the managements have less incentives to disclose information voluntarily which may lead to a break down of the external financing system. [377]

While the legal system brings justice to the investors, penalties must be high for the lawbreakers, which will act as a deterrent to others.

"Whenever a statute or regulation requires a particular act to be done in a particular manner and also lays down that failure to comply with the said requirement leads to a specific consequence, the same is mandatory in nature but if it does not specify the consequences it will only be Directory in nature." [378] The law must provide legal penalties for attempts to defraud the external parties through false and misleading statement, deliberate overstatement of facts and omitting to state material facts. The penalties must be high and strictly enforced.

Various provisions relating to the liabilities and the powers of the regulatory authorities are discussed next.

1. Director's Liability

The law does not impose a code of conduct or a separate list of Directorial duties. Some duties are specified in the statutes while others are found in the general law. A Director of a company has fiduciary duties, which is based on trusteeship, which must not be exploited for personal gain. A Director is expected to exercise skill and care and must not be negligent in performing his

[376] As stated in the Naresh Chandra Committee report, the Department of Company Affairs has not been able to secure a single jail term in the last 50 years Supra note 358 at Para 5.32
[377] R. La Porta et al, " Investor Protection and Corporate Governance", 58(1) *Journal of Financial Economics* 6, 3-26 (2000)
[378] M.V. Subramanyam and Another v. Union of India and Others SC, Company Cases 211 Vol 112, 2002 (AP)

duties. The Companies Act imposes a number of duties on the Directors. These include maintenance of books, filing of proper documents, and seek approvals wherever necessary. The Act imposes certain liabilities on Directors. A Director is an officer of the Company as defined in Section 2(30) and Section 5 defines an 'Officer who is in default'.[379] The Act specifies the Director's liability in the following areas;

Under Section 73, the Directors are personally liable along with the company to repay the share application money or excess application money if not repaid within the time limit stipulated. Similarly, Section 62 stipulates civic liabilities for damages for a mis-statement in a prospectus issued by the company and the Director's responsibility to pay compensation to the persons who have subscribed to the shares of the company relying on the statements. Section 63 provides for criminal liability for mis-statements in the prospectus with a maximum punishment that may extend to two years or a fine a fine up to fifty thousand or both. The fine seems to be on the lower side inspite of the recent increase. Very few cases have been found leading to imprisonment although there were some before the existing Act came into force. When the punishments are not stringent enough or there is reluctance to use them effectively, then unscrupulous promoters will never be punished.

A number of sections contain penal provisions under the Companies Act for offences. If a company defaults in complying with the provisions, the company or any officer of the company who is in default shall be punishable with imprisonment for a term which may extend to two years, or with fine which may extend to fifty thousand rupees, or with both. The offences are, of course compoundable under Section 621A of the Companies Act, 1956.

In the US, the Sarbanes Oxley Act imposes stringent fines on persons who are responsible for filing statements that are untrue. These fines extend up to $1 million and /or imprisonment up to 10 years. Further those who wilfully provide wrong certification knowing that it will not meet the legal criteria can be punished with a fine if $ 5 million and/or a prisor term of up to 20 years.

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[379] In order to avoid prosecution a director can delegate the responsibility of compliance of the Act to an employee in which case the person so appointed will be the officer in default.

2. Liability for non-reporting

In respect of annual accounts, the Companies Act under Section 210(5), states that 'any person, being a Director of a company, who fails to take all reasonable steps to comply with the provisions of this section, shall, in respect of each offence, be punishable with imprisonment which may extend to six months or with a fine which may extend to Rs 10,000 or with both. The fine is a small amount and is not stringent enough to act as a deterrent for giving false statements.

The ROC (by a written order) can call for documents and additional information on any documents filed with it. On default the company and each such person shall be punishable with fine that may extend to five thousand rupees and in the case of a continuing offence, with an additional fine, which may extend to five hundred rupees for every day during which the offence continues. The ROC can also go to the court for making an order for production of these documents and information.

An investor who reads the annual report can make sense of what is said but many a time, is at a loss to know what is hidden and what ought to have been disclosed. In such cases when the investor relies on the annual report and purchases the securities, and suffers losses based on these statements, they must get succour through the legal system. At present compensating an investor for acting on fraudulent information is not specifically covered by the statute. Section 628, provides that when false statements are made in any return, report, certificate, balance sheet, prospectus, statement or other document required by or for the purposes of any of the provisions of this Act, any person who makes a statement, which is false in any material information, knowing it to be false, or omits material facts, then such persons will be punished with imprisonment for a term which may extend to two years, and shall also be liable to fine. If any person intentionally gives false evidence he shall be punishable with imprisonment for a term, which may extend to seven years, and shall also be liable to fine under Section 629.

The stock exchange requires listed companies to file certain documents as well as the publishing of quarterly reports. Certain disclosures are also mandated through the listing agreements in the annual report. If there is a

default by a company, the stock exchanges do not have sufficient power for stringent penalty, except through de-listing or sending to Z category, which will cause hardship to the investors. The law in its present form is inadequate and has to be more stringent on defaulters.

3. Power to Investigate

Under section 235, The Central Government may, where a report has been made by the Registrar under sub-section (6) of section 234, or under sub-section (7) of that section, read with sub-section (6) thereof, appoint one or more competent persons as inspectors to investigate the affairs of any company and to report thereon in any such manner as the Central Government may so specify. The application to the Central government can also be made by not less than two hundred members or from members holding not less than one-tenth of the total voting power in case of company not having a share capital.

The Central Government has also power to initiate an investigation of a company under section 237 on application by a) the company, by special resolution, or (b) the Court, by order, (c) under certain circumstances when requested by the Company Law Board.

Shareholders can also apply under section 397 and 398 for relief from oppression and mismanagement to the Company Law Board if the affairs of the company are being conducted in a manner prejudicial to public interest or in manner oppressive to any member. The application can be made by, not less than 100 members of the company or by any member/s holding not less than 1/10 of the issued share capital in case of a company having share capital whichever is less.[380] If the numbers fall short, then the shareholders can approach the Central Government to reduce the limit on equitable grounds. The Company Law Board may provide for a) the regulation of the conduct of the company's affairs in future, b) the purchase of the shares or interests of any members of the company by other members thereof or by the company c) in the case of a purchase of its shares by the company aforesaid, the consequent reduction of its share capital d) termination, setting aside or modification of certain agreements and certain contracts for delivery of goods or any other

[380] An exploration of the case laws under this section reveals they are related to other issues, like family splits etc., than any issue of mismanagement.

matter. The Central Government also has power to appoint such number of persons as is necessary, as Directors of the company, to safeguard the interest of the company, its share holders or in the public interest (Sec 408). The procedural delays many a times dissuade the investors from taking this route.

4. Compensation

Under the general law there are no special provisions for disgorgement of profits in India. In the US, the SEC can file a suit for disgorgement of profits. In a case filed against Xerox for false and misleading annual reports, which did not confirm to GAAP thereby overstating the earnings, the Executives had to pay about $22 million in Penalties, Disgorgement and Interest. The Commission previously brought two other injunctive actions based on the same fraudulent scheme as was alleged against the senior Xerox executives, as well as other allegations. Without admitting or denying the allegations of the complaint, Xerox consented to the entry of a final judgment that permanently enjoined the company from violating the antifraud, reporting and record keeping provisions of the federal securities laws. Xerox also paid a $10 million civil penalty, agreed to restate its financial statements and agreed to hire a consultant to review the company's internal accounting controls and policies.[381] Similar provisions for disgorgement are also found for new issues and insider trading. In the recent enactment, Section 304 of the Sarbanes-Oxley Act of 2002 provides that if an issuer is "required" to prepare an accounting restatement due to material noncompliance with securities law financial reporting requirements as a result of misconduct, the CEO and CFO must reimburse the issuer for any bonus or other incentive or equity-based compensation "received" during the 12-month period following the first public issuance or filing with the SEC of the deficient financial document, and any "profits" realised from the sale of the issuer's securities during that 12-month period.

There is no provision under the Companies Act that enables an investor to claim compensation from the erring management. Compensation is available

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[381] Securities and Exchange Commission v. Xerox Corporation, Civil Action No. 02-CV-2780 (DLC) (S.D.N.Y.) (April 11, 2002). See Litigation Release No. 17465 / April 11, 2002/Accounting and Auditing Enforcement Release No. 1542 / April 11, 2002. SEC v Paul A and others Civil Action No. 03 CV 4087 see http:// www.sec.gov/litigation/ complaints/ comp18174.htm Accounting and Auditing Enforcement Release No. 1796 (June 5, 2003,)

under Sections 73 and 74 of the Indian Contract Act, which deals with breach of contract and consequent compensation. Section 73 provides that a person who suffers from breach of contract is entitled to receive compensation for any loss arising from the breach. The parties are however, free to settle the case by payment in case of anticipation of a particular loss arising from a given breach. Section 74, which deals with penalty, provides that when a contract has been broken, if a sum is named in the contract as the amount to be paid in case of such breach, the affected party is entitled to receive the amount, whether or not actual loss is proven. Thus the investor can claim only losses or damages to the extent arising from a breach. It is recommended that the judicial system/consumer forum/ National Company Law tribunal have powers to award compensation when investors invest relying on fraudulent financial reporting.

The recent amendments to SEBI Act, gives more powers to investigate market offences, enforce regulations and impose different penalties. Deterrent fines that can extend upto 25 crores or up to 3 times the undue profits made have been enacted. The penalty amounts have also gone up.

Private litigation rights are the single most essential requirement for an efficient disclosure system. Without a system for penalising inadequate financial disclosure and reporting, other institutional changes are doomed to fail.[382]

Class Action Suits

"It is far more important to empower the investor than to empower the regulator"[383]

In the US, class action suits by shareholders is very common. For example if there is a decline in the share price, which is also due to any misinformation/ non-communication, shareholders can sue the companies. SEC investigation can often trigger a drop in stock prices or encourage the filing of shareholder suits. It acts as an important legal deterrent. A class action is a lawsuit filed by one or more plaintiffs (who are known as the "named plaintiffs") on behalf of others who have a similar legal claim. Because they allow people to join together as a group in one lawsuit against common defendants, class actions are important for consumers.

[382] R. Ball," Infrastructure requirements for an economically efficient system of public financial reporting and disclosure", *Brookings- Wharton Papers on Financial services, 127-182, 2001*
[383] J. R. Varma See Supra Note 337 at 9.1.3

The Federal Rule of Civil Procedure 23 specifies the prerequisites for class action, where one or more members of a class may sue or be sued as representative parties. Class action suits are permissible only if a) the class is so numerous that joining of all members is impracticable b) there are questions of law or fact common to the class c) the claims are same to the class d) representative parties will fairly and adequately protect the interest of the class. Once the action is taken the courts will determine whether such actions brought as a class action, are maintainable as class action suits. All further compromise or dismissal can be done only with the approval of the court. The ability to join together in one lawsuit is particularly important for the judicial system to function efficiently. Without class actions too many claims might theoretically flood the court system. Instead, the class action procedure encourages the filing of one single case on behalf of all people harmed, minimising the need for thousands of individual cases. By spreading the costs of litigation, which can be substantial, among many people, each individual claim can achieve justice. Class actions, comprised of groups of consumers working together to stand up for their rights, demand the attention of corporations and other wrongdoers.

Class actions makes it possible for a few people to change corporate practices and to bring wrongs to the attention of the court on more than a piecemeal basis. The claims may result in a settlement but they usually force the defendant business into adapting their policies to eliminate the practices that lead to the class action. In this way all of society benefits in way that is hard to quantify beyond the members of the class who receive compenstation. An important prerequisite is an independent, efficient and effective judicial system or process that would address such issues expeditiously.

The Indian litigation process involves huge cost and time for the individual investor; a class action suit may be the answer to claims of the minority shareholders. More importantly, class actions encourage more responsible behavior on the part of corporate defendants. The present public interest litigation has not really taken of in India and hence a different legal mechanism for the investor must be initiated. The threat of legal action may induce management to voluntarily disclose information whether there is profit or otherwise. In a disclosure based regulatory system, class action suits will go a long way in investor protection. The accumulated pending litigation in Indian

courts does not augur well for successful implementation of this proposal; but the answer does not lie in rejecting this suggestion but hastening reforms in the judicial processes.

While fraud detection some time fails, investigations move at a fast speed after they come to light. In the Enron Case, the statutory auditors ceased to exist as a result of legal charges brought against them. Speedy, effective and fair trial after detection holds the key. The recent amendment to the Civil Procedures (Amendment) Act 2002 should help accelerating judicial process.

The present legal system discourages the retail investor from approaching the court for redressal as it involves time and cost. A suit under a representative action may take three to five years. In such cases, a quasi-judicial body, which is specialised, and can understand the accounting, company law and related matters, like the National Company Law Tribunal can bring about speedy dispensing of justice.

6.3.3 Statutory Audit

"The Chartered Accountant is a person on whom every section of society could rely upon, and rely strongly. His certificate would be one by way of a seal and a hallmark which would at once inspire confidence in the minds of all concerned as certification by a person fully competent and holding a charter from the supreme legislature of the country for the purpose… "[384]

Modern corporations or the corporate form of organisation is a relationship or a contract between various factors of production. In order to facilitate such contracting it is important for various parties to the contract to have reliable financial and non-financial information. An integral part of the financial reporting process is the statutory audit. The use of independent audits were demanded since the days of English Merchant guilds in the eleventh century to the time when audits were required by law in the twentieth century.[385]

The American Accounting Association (1973) describes auditing:

"as a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users."

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[384] ICAI, *History of the Accounting profession in India,* 11 viii-ix (New Delhi, ICAI 2001) also as quoted in the Naresh Chandra Committee Report Supra Note 373 at 2.03

[385] R. Watts and J. Zimmerman, "Agency Problems, Auditing, and the Theory of the Firm: Some Evidence". 26(3) *Journal of Law and Economics* 613, 613-633 (1983)

Audit concerned with the verification of accounting data with determining the accuracy and reliability of accounting statements and reports. Auditing primarily involves testing the reliability, competency and adequacy of evidence in support of monetary transactions. The main objective of the company audit is to conduct an independent review of the financial statements and offer an opinion about their reliability in representing the organisation's financial condition and working results. The main function of the auditor is to ascertain whether the financial statements fairly represent the actual financial position and the working results of an organisation.

Audits add value to financial statements by improving their credibility as management of the companies have to set right the financial statements in view of the auditor's comments which reflects on the financial statements. Even when audits do not result in corrections to the statements, they make financial statements more reliable by ensuring that the management avoids misstatements and also to consult with auditors about how to account for complex transactions before those transactions are recorded.[386]

Audits are also important from the capital market perspective. Audited financial statements are perceived to transmit positive signal to users regarding the accuracy of management disclosures, which will enable the various parties to contract with assurance.[387] Credibility of the financial statements mean that stakeholders believe that an entity's financial position, results of operations, and cash flows are in agreement with accounting principles in all material respects and hence the stakeholders will perceive the financial statements to be more reliable because they were audited.[388] Stakeholders' confidence in the reliability

[386] The auditor's ability to improve the reliability of financial statements is limited by the nature of the audit process. Audit evidence may be persuasive but rarely is conclusive, and even persuasive evidence is obtainable only at a cost. Additional auditing procedures might increase the persuasiveness of the evidence obtained, but at a cost that might exceed the benefit of the additional procedures. Acts of fraud such as concealment, and falsified documents limits the auditor's role for improving the reliability of the financial statements.

[387] Cadbury Committee Report, Supra note 22 at 36

[388] Researchers who use a contracting perspective to study auditor independence express this idea differently. For example, DeAngelo notes that "the ex-ante value of an audit to consumers of audit services (which include current and potential owners, managers, consumers of the firm's products, etc) depends on the auditor's perceived ability to (1) discover errors or breaches in the accounting system, and (2) withstand client pressures to disclose selectively in the event a breach is discovered, See L. E. De Angelo, Supra note 319 at 115.

of the financial statements may affect their perceptions of information risk and their resource-allocation decisions. Improved financial statement reliability reduces information risk and this in turn helps lower the cost of capital of a company. At the same time audits increase the usefulness of the financial statements for the users improving the allocation function of the markets.

The academic literature has shown great interest in examining how firms employ mechanisms to mitigate agency conflicts between firm's managers (or promoter owners) and outside shareholders, to increase firm value[389] and also to increase transparency in dealings. A method identified to alleviate the problem is to appoint an independent external auditor to testify to the accuracy of the firm's financial statements. The role of auditor is derived from the need of the society for an independent and expert examination of financial information and for expression of an independent expert opinion on the result of the examination.[390]

The auditor's role in monitoring and thereby diminishing the agency problem and ensuring the quality of accounting information has been a subject of debate. Research provides evidence of audit user dissatisfaction with the role of auditor's responsibility. They are generally dissatisfied with the auditor's role in fraud detection, going concern and general conduct of business. [391] In Asian countries, as discussed by Backman, auditing is against the general culture where business transactions are relationship based. The need to audit the accounts would suggest distrust and may lead to confrontation.[392]

Auditors perform three kinds of services, consisting of audit, review, and compilation work. Sections 224 to 233A of the Companies Act lay down provisions relating to auditing and statutory auditors. The Union government on the advice of Comptroller and Auditor General of India appoints the statutory auditors for Government companies. The Comptroller and Auditor General also

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[389] M. Jensen and W. Meckling, Supra Note 86, 305-360

[390] Quoting Lindburg in Y. H. Malegam, "The Role of Accounting Professional", XLVI (7), *The Chartered Accountant* (1998) at 11

[391] C. Humphery, P. Moixer and S.Turley, "The Audit Expectations Gap in Britain: An Empirical Investigation", 23 (91A) *Accounting and Business Research* 395-411 (1993) There is, however, a lack for evidence of a direct link between a firm's agency problem and its auditor choice in the US. literature although research shows that they do fulfil the assurance role.

[392] M. Backman, *Asian eclipse: Exposing the Dark Side of Business in Asia* 10 (Singapore: John Wiley, 1999)

directs the manner in which audit should be conducted. He is also empowered to comment upon the audit reports of the primary auditors. In addition, he conducts a supplementary audit of such companies and reports the results of his audit to Parliament and State Legislatures.

An auditor normally reports on many items and these include i) the accuracy of the financial statements ii) the efficiency of the management and its policies and iii) discovery of frauds and irregularities to a limited extent. These and the various provisions of the Act indicate that the shareholders are entitled to an independent view of the company and the statutory auditor is in a way holding a fiduciary position.

Some studies examine the role of external auditors with special reference to the big five auditors. A study by Becker indicated that earnings management was negatively related to the big five auditors[393] and in mitigating the agency problem and providing assurance in the quality of reporting. The argument for this view is that big auditors will exert pressure on the companies as they themselves have their reputation to consider.

The recent fall of companies like Enron and WorldCom in the US and Pol.y Peck and BCCI in the UK and the East Asian financial crisis have raised the questions about the role of auditors and the effectiveness of audits and also the role of the big auditors. The auditors in all such cases issued clean auditing reports and the companies went bankrupt within a few months from the completion of their audits. The failure of audits has mainly been attributed to the auditor's independence or the lack of independence in these cases. Global auditors audit multinational companies all over the world and have subsidiaries that will audit the multinational companies. To this extent the auditor's independence gets diluted.

Auditor Independence

Auditor independence is fundamental to the credibility of the auditors' report. Auditor independence requires a freedom from bias and personal interest. It also means that the auditors are not having a prior commitment or an

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[393] C. L.Becker, *M.L.*Defond, J. Jiambalvo, K.R. Subramanyam, "The Effect of Audit Quality on Earnings Management", 15 (1) *Contemporary Accounting Research* 1-24 (1998)

interest or susceptibility to undue influence or pressure.[394] An independent audit is a key element in the corporate governance structure. Auditors can be independent and effective monitors when they will report breaches of contract between the shareholders and the management and will report any omissions or misstatements in the financial statements.

Many reasons have been attributed to auditor independence problem. At the apex of a company's decision-making process is its Board of Directors who are appointed in a way by the management of the company or the promoters of the company. In India and UK the law states that the shareholders of the company appoint the auditors in the annual general meeting. However, in practice, these auditors are appointed by the management or promoter Directors and the shareholders merely ratify this at the annual general meeting. In the US too, the Board nominates the auditors for election in the annual meeting. However, either due to proxy votes given to the management or due to indifference of the shareholders all related decision was left to the management except when there was an adverse situation.[395] The auditors are not only selected, but the management and the controlling shareholder also decide their compensation and renewal or their appointment. In effect, the auditors see the Directors/promoters as their clients and are less likely to disagree with them.

Direct financial interest, indirect interest, and close relation with the client and dependence on the client's fees have also contributed to the independence problem. In the US after the recent collapse of companies there has been a debate about the audit and non-audit services and the fees that the auditors receive on account of services other than audit. By receiving higher non-audit fees it is perceived that the statutory audit may be lax as the auditors may compromise in their need to get consulting business. The independence of the auditor may be affected by the auditing and consulting roles of auditing firms as firms receive fees for non-audit service as much as for the audit services if not more,[396] which may weaken the auditors' incentives to be independent and

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[394] ICAA, "Audit Independence", *The Australian Statement of Auditors Practices AUP 32*, 1 (2001)

[395] A. R. Abdel-khalik, "Reforming Corporate Governance Post Enron: Shareholders' Board of Trustees and the Auditor", 21(2) *Journal of Accounting and Public Policy* 97-103 (2002)

[396] In the Case of Enron for example 25 $ million was the audit fees and 27$ million was the non-audit fees.

consequently their credibility as effective monitors and may be more prone to management's pressure in earnings management. Researchers found that for a set of firms who were involved in frauds, the non-audit component were significantly related to the audit fees in the US. Some studies also found that while the share of non-audit fees was increasing, there was no conclusive evidence that the auditor's independence was affected. A study of Australian companies also reached a similar conclusion.[397] In India, fees paid to the auditors are to be reported under various heads like audit fees, fees for other services, tax audit fees and out of pocket expenses etc. The fees for other services include other certification work. The audit fees and the non-audit fees of companies in the BSE 100 (other than public sector companies) are reported in Appendix 13. The non audit fees to total audit fees including tax audit ranges from 1.9 times the audit fees to just .1 times the audit fees. There are 19 firms in the list where the non-audit fees exceed the audit fees paid and a few that are in the verge of exceeding the audit fees.[398] The result can be interpreted as either Indian companies do not appoint the auditors as consultants so that there is a perception of the auditors independence[399] or that they do not have that many consulting assignments involving audit firms. An alternate interpretation can be that the non-audit fees themselves may be quite low.[400]

Auditor independence is a major area of concern and researchers and regulators are looking at various solutions. The recent Sarbanes Oxley Act, 2002 in the US, now makes it unlawful for a registered public accounting firm to perform both audit and certain non-audit services. The prohibited non-audit services include services like book keeping, financial information systems design and implementation; appraisal or valuation services, actuarial services; internal audit outsourcing services, human resources services, legal services unrelated

[397] M. Bajaj, K.Gunny and A. Sarin, "Auditor Compensation and Audit Failure: An Empirical Analysis", papers.ssrn.com/sol3/papers.cfm?abstract_id=387902 (Nov 11, 2003) see also L.Barkess and R. Simnett, "The Provision of Other Services by Auditors : Independence and Pricing issues", 24(94) *Accounting and Business Research* 99-108 (1994)

[398] The audit guidelines require that non audit fees should not exceed the audit fees.

[399] As put by Firth and also by Prakash et al these firms may be high agency cost firms. M. Firth, "The Provision of Non-Audit Services by Accounting Firms to Their Audit Clients", 14 (2), *Contemporary Accounting Research* 1-11 (1997) M. Prakash, and C. Venable, "Auditee Incentives for Auditor Independence: The Case of Non Audit Services", 68 (1) *The Accounting Review* 113-133 (1993)

[400] Although as compared to other countries the payments are quite inadequate. See Naresh Chandra Committee Report Supra note 358 at 2.06

to audit. Any other services can be performed with the approval of the audit committee. These restraints are enacted to ensure auditors independence. Apart from these the Code of Conduct also specifies additional conditions for maintaining the auditors independence. IFAC identifies nine areas of non-audit services that is a possible threat to auditor independence.[401] The audit, non-audit fee discussion has a mixed reaction in different part of the world. Both the Ramsay Report of Australia and the Naresh Chandra Committee do not subscribe to the link of audit failures to non-audit fees. Further, they believe that a ban should not be imposed in the absence of evidence to the contrary. There are certain services that are not allowed to be provided by an audit firm at present. The Naresh Chandra Committee also recommends a list of services that should be prohibited.

A more important aspect of the audit, non-audit fees discussion is the amount of fees from a client to the total fees of the audit firm which may show the dependency of the firm on the audit as a main source of income which may affect the independence of the auditor. Naresh Chandra Committee recommends that the fees received from a client and its subsidiaries and affiliates together from non-audit service should not exceed a limit of 25 % of the total revenue of the audit. This will not be applicable to new firms for five years and firms that have total revenue of less than Rs. 15 lakhs per year.

Many researchers have suggested mandatory audit rotation to maintain the auditor independence. The rotation of auditors has been under study for more than forty year in the US. [402] Mandatory rotation implies that there will be a limit set on the number of years an auditor can audit a company. The theoretical argument put forth for this proposal is that with longer audit tenure, the association between the auditor and the Directors may lead to familiarity threat[403] or the objectivity will be lost which may impede the auditor

[401] These services are Valuation services, preparation of financial statements. Internal audit services, IT system services, temporary a staff assignments, legal services, recruitment services and corporate finance services, IFAC.

[402]J. Myers. L.A. Myers and T. A Omer, " Exploring the Term of the Auditor-client Relationship and the Quality of Earnings: A case for Mandatory Auditor Rotation ? http:// ssrn. com/ abstract=315120(June 7, 2002)

[403]The findings of ICAEW as quoted in R. Hussey and G. Lan, " An Examination of Auditor Independence Issues from the Perspectives of UK Finance Directors", 32(2) *Journal of Business Ethics* 171, 169-179 (2001)

independence. Opponents of mandatory rotation suggest that mandatory rotation will lead to increase in the audit cost and reduce efficiency, as the new auditor will take time to understand the nature of the business and the procedures of the client. In the US some studies also indicate a greater proportion of audit failures when there are new clients.[404] In practice, it may also be possible to overcome this rule if audit firms have associates etc.

Abdel-khalik suggested a change in the institutional arrangement of appointment of the auditors. He suggests that the shareholders set up a Shareholders Board of Trustees (SBT) whose responsibilities would be the to appoint, remunerate and replace the auditors.[405] The shareholders appoint this Board of trustees, and who will in turn select and appoint the auditors. The Board would have no power in the appointment of the auditors. The Board and the SBT will have no common members. The Shareholders Board of Trustees will have power to call for meeting with the auditors who would be accountable to the shareholders through the SBT. This system will maintain the auditor independence in a dispersed scene like in the US. In India the controlling shareholder will have a major role in the appointment of SBT and hence one can recommend that only non-promoter shareholders should appoint the trustees. Promoter holders should not vote on such resolutions appointing auditors, in which case it would truly imply that the auditors are not appointed by the management but by the other shareholders and financial institutions. However, this arrangement implies that all shareholders do not get the same rights.

In the emerging markets and countries like India the statutory audit loses its value if the legal enforcement is weak and no action is taken against the companies when there is an audit qualification. Auditing is also difficult when business dealings are opaque in nature.[406] Scholarly research also suggests that compared with the more developed economies, the lack of audit expertise in emerging markets could weaken auditors' monitoring role. Many also feel that lack of effective regulatory mechanisms for the auditing profession may result in weak audit mechanisms.

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[404] L.Berton, "GAO Weighs Auditing Plan For Big Banks", *Wall Street Journal*, 27 March 1991: A3
[405] See Abdel-khalik, Supra Note 395 at 101
[406] Backman, Supra Note 392 at Chapter 2 and 4

An independent auditing standard setting body is also envisaged by many. This argument is however opposed by the profession, as it feels that it may lead to inflexible framework without any advantage of the getting the best of the experience of the accounting profession.[407] In the US a new independent supervisory body, the Public Company Accounting Oversight Board (PCAOB) has been constituted to oversee the independence requirements of the auditors. Section 105 of the Sarbanes-Oxley Act of 2002 grants the PCAOB broad investigative and disciplinary authority over registered public accounting firms and persons associated with such firms. To implement this authority, Section 105(a) directs the Board to establish, by rule, fair procedures for the investigation and discipline of registered public accounting firms and associated persons of such firms.[408] This Board has the power to establish auditing and related attestation standards, quality control standards, and ethics standards to be used by registered public accounting firms in the preparation and issuance of audit reports. This is as required by the Act or the rules of the Commission, or as may be necessary or appropriate in the public interest or for the protection of investors.

The Naresh Chandra Committee has recommended an Independent Quality Review Board, to examine and review the quality of audits with a chairman nominated by the DCA. It is recommended that the Quality Review Board be established in the lines suggested in the Naresh Chandra Committee Report.

While regulation is necessary, ultimately the auditor's independence is about "knowledge of the discipline, professionalism, integrity and fiduciary responsibility"[409] that cannot be enforced only through legislation.

Audit Procedures and Audit Report

Auditors are required to express an opinion on the financial statements and have to state that the financial statements give a true and fair view of the state of affairs and the profit or loss for the year. They also have to report if proper books of accounts have been maintained and the company's financial

[407] Naresh Chandra Committee Report, See Supra Note 358 at 3.11
[408] From the website of the Board at http://www.pcaobus.org/pcaob_enforcement.asp (Aug 05, 2002)

statements are as per the books. They also verify if the accounts are prepared as per the accounting standards referred in Section 211 (3C) of the Companies Act. The auditors also report on the adequacy of internal control procedures like inventory valuation, maintenance of various books etc. Additionally, auditors have to report about items specified in the Companies (Auditors Report) Order, 2003.[410] Certain specific procedures have also to be followed while performing the audit. The Auditors report has to make specific comments or report on the various items given in the CARO. For example, whether the fixed assets are physically verified during the year, whether loans and advances have been given and whether the interest and principle are being collected as per schedule. The details required to be given in the auditors report is summarised in Appendix 14. These are quite elaborate and audit qualification may get lost in the whole report even if they are given in italics.

Company auditors are guided in their practice by a number of written pronouncements like the a) technical norms issued by the ICAI like the Auditing Guidelines and Standards b) Accounting Standards and the c) Companies Act. The Auditing and Assurance Standards (Generally Accepted Auditing Standards (GAAS) in the US) also guide them. The auditing standards give guidance to the auditors in a number of matters including the need for adequate planning and supervision, adequately trained personnel, the need for independence, and the need for due professional care, understanding the internal control and evidential matters to afford a reasonable basis for the auditor's opinion.

In the US in addition to GAAS there is also Statement of Auditing Standards pronouncements, which are quite detailed. Financial statement credibility may improve when an auditor performs a quality audit. The Standard Auditing practice has introduced peer review to reaffirm the quality of audit. The level of audit quality is a function of many factors, including the personal attributes of the individual auditor, the control within the firms, the development of the auditing profession and the independence of the auditor.

International audit standards maintain that an auditor's mandate may require him to take cognisance and report matters that come to his knowledge in

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[409] Supra Note 358 at Para 2.07.

[410] Earlier Manufacturing and Other Companies (Auditors Report) Order, 1988 in terms of Sec 227(4A) of the Companies Act, 1956

performing his audit duties which relate to: Compliance with legislative or regulatory requirements; Adequacy of accounting and control systems; Viability of economic activities, programmes and projects.

Section 10A of the Reform Act in the US specifies procedures to be followed by auditors in their audits. These procedures are designed to provide reasonable assurance of detecting illegal acts that would have a direct and material effect on the determination of financial statement amounts. They also include identifying related party transactions that are material to the financial statements or otherwise require disclosure therein; and an evaluation of whether there is substantial doubt about the ability of the company to continue as a going concern during the next year. SEC has started initiating action against the auditors for not reporting illegal acts.[411] Audit reports in the US are not that elaborate. It is recommended that the audit report be kept short and only exceptions are reported instead of reporting all the items. If required a more detailed report may be filed with the ROC and the Stock exchange. The provisions relating to audit under Sarbanes Oxley Act is summarised in Table 6.2

Audit Qualification

If in the Auditor's Report, there is a qualification or there are unfavorable remarks about certain items, the Auditor's Report shall state the reasons for such unfavorable or qualified remarks, as the case may be. Where the auditor is unable to express any opinion in answer to a particular question, his report shall indicate such fact together with the reasons why it is not possible for him to give a reply to such question.

The audit qualification is not a deterrent in India as there is no penalty or enforcement issues or rejection of the financial statements as in the US. It is recommended that when an audit report contains qualification, it should be made mandatory for the audit firm to send a copy of the qualified report to the Registrar of Companies, SEBI and the Stock Exchange, about the qualifications made, with a copy of this letter being sent to the management of the company. This

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[411] SEC v. Solucorp Indus., Ltd 197 F. Supp. 2d. 4 (S.D.N.Y. 2002) In re Rosetti, Accounting and Auditing Enforcement Release No. 1338, [S.E.C. Accounting Rules] Fed. Sec. L. Rep. (CCH) 74, 845, at 63, 519 (Oct 31, 2000).

could be sent within 15 days of signing the report. This is mainly to enable the regulators such as ROC and SEBI to probe and question the companies regarding such qualifications.[412]

Liability of Auditors

The company is primarily responsible for the preparation of the financial statements. Hence the fundamental responsibility of the accuracy of the financial statements is that of the management and the Directors. The nature of auditors' liabilities is therefore secondary to that of the management. When an independent auditor audits the financial statements, it gives the users a positive indication that they are accurate in terms of disclosures made, thus ensuring reliability.

In an external audit, the auditor who undertakes to examine the books and audit the accounts of a company does not guarantee the correctness of the accounts. He does undertake to use skill and due professional care and to exercise good faith and to observe generally accepted auditing standards and professional guidelines, with reasonable judgment that a professional and prudent auditor would use under the same or similar circumstances. Reasonable adherence to the standards requires application of experience, skill, and the exercise of independent judgement. The auditing standards concern themselves not only with the auditor's professional qualities but also provide that he may exercise judgment in the performance of his examination and in his report.

The ability of the firm's shareholders to sue the auditors arises from relying on inaccurate financial statements. The auditor's liability can arise when there are financial statements errors and deliberate misrepresentations or concealment of facts and frauds. The auditor's responsibility to consider frauds and error in the financial statements is an inherent limitation of an audit as given in the Standard Accounting Practice (SAP 4) on fraud and error, read in conjunction with the `Preface to the Statements on Standard Accounting Practices.' According to SAP 4, the responsibility for the prevention and detection of fraud and error rests with management through the implementation

[412] Proposed in the Companies Amendment Bill and in the Naresh Chandra Committee report.

and continued operation of an adequate system of internal control. Such a system reduces but does not eliminate the possibility of fraud and error. As seen in Chapter 4 the accounting standards require the use of judgements and estimates. An auditor cannot guarantee that all material misstatements can be detected, as the evidence he has is persuasive and not conclusive. Moreover frauds committed by the management and top management are not easily detectable as they are in a position to over ride the internal controls with their authority or through collusion. Due to the inherent limitations of an audit there is a possibility that material mis-statements of the financial information resulting from fraud and, to a lesser extent, error may remain undetected. The auditor in such cases can only give a reasonable assurance about the correctness of the financial statements. The auditing standard further states that "The subsequent discovery of material mis-statement of the financial information resulting from fraud or error existing during the period covered by the auditor's report does not, in itself, indicate that the auditor has failed to adhere to the basic principles governing an audit. The question of whether the auditor has adhered to the basic principles governing an audit (such as performance of the audit work with requisite skills and competence, documentation of important matters, details of the audit plan and reliance placed on internal controls, nature and extent of compliance and substantive tests carried out, and so on) is determined by the adequacy of the procedures undertaken in the circumstances and the suitability of the auditor's report based on the results of these procedures..."[413] When fraud or misstatement is committed intentionally then the auditor is liable for not only the damages but also disciplinary and regulatory actions by the professional institute.

In the US, apart from the professional standards set by the accounting profession, the Statement of Auditing Standard (SAS) No. 53 titled 'The Auditors' Responsibility to Detect and Report Errors and Irregularities'[414] was first issued and later superseded by the SAS 82 in Dec 1997, called as 'Consideration of Fraud in a Financial Statement Audit,' and SAS No. 54 entitled 'Illegal Acts by

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[413] ICAI, "The Auditors Responsibility to consider fraud and error in audit of financial statements AAS 4", 51 (8) *The Chartered Accountant* 808 (2003)

Clients.' These were important to judge the financial statements. In 1995 The Private Securities Litigation Reform Act of 1995 (Reform Act) was enacted which contains a provision which requires auditors to detect fraudulent financial reporting and illegal acts and to report such illegal acts in their audit procedures. The auditors are also responsible for the undetected material misstatements and had to pay for the legal fees whether they prevail in the court or not.[415] Thus, this is a different approach to the frauds and errors in the financial statements. It was held in Tri-sure India Ltd. *v* A. F. Ferguson and Co. and Others[416] that the auditor was not guilty of negligence when not detecting frauds. As stated, the main objective of the company audit is to conduct an independent review of the financial statements and offer an opinion about their reliability in representing the organisation's financial condition and working results, which involves testing the reliability, competency and adequacy of evidence in support of monetary transactions. The auditor's liabilities can be broadly classified into those of i) civil and criminal liability ii) liabilities under the Companies Act iii) liabilities arising out of professional misconduct.

A civil liability can be instituted against the auditors for any damages incurred by parties due to the negligence while discharging of duties. Liability also arises because of breach of contract and frauds. Auditors have a duty to exercise due care, skill, and competence that are needed by a reasonably competent member of a profession. The auditor's duty is to act honestly, in good faith, and with reasonable care in the discharge of professional obligations. If he has not performed his duty with care and skill then he is liable for negligence. Civil liability for negligence arises when it is proved that an auditor's client suffered a loss due to the auditor's professional negligence. Three things must be established here: a) that there was negligence by the auditor in the performance of his duty; b) that loss or damage was caused as a result of this negligence and; (c) that this loss or damage was suffered by the client.

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[414] AICPA, *Codification of Statements on Auditing Standards* -SAS No. 53 (Sarasota: Auditing Standards Board, 1988)
[415] In the study the authors investigated the issue of legal fee payments made. R. Smith and D. Tidrick, "The Effect of Alternative Judicial System and Litigation Cost on Auditing", 2(3) *Review of Accounting Studies* 353-381 (1988)
[416] Tri-sure India Ltd. *v* A. F.Ferguson And Co. and Others 1987-(061)-Compcas -0548 -BOM

The auditor's liability for negligence is owed to the person who appoints the auditor or with whom he has the contractual agreement. The liability is to the shareholders, albeit not as any individual shareholder. The liability for negligence must evidence the fact of breach of standard of care, which causes the shareholder the damage. Malpractice litigation costs for the some largest accounting firms accounted for nearly 12- 14% of their audit revenues, and today these firms face billions of dollars in securities fraud claims in the US.[417] For example, Arthur Andersen agreed to pay $217 million to settle suits arising from its role as auditor of the Baptist Foundation of Arizona, investors in which were affected by sham transactions that hid massive losses. Also, Andersen paid $110 million to settle suits arising from its audit of Sunbeam during the reign of CEO Chainsaw A Dunlap, and $75 million to settle a suit brought by Waste Management, Inc., in 1998. Ernst & Young paid more than $335 million for its role in the Cendant Corporation case.[418] The recent Sarbanes Oxley Act also levies high amount of penalty and imprisonment.

Liability under the Act

Prior to the amendment of Section 2(30) the term "Officer" defined in the Act included the auditors. The auditors were liable under the Act when there was default under sections 477, 478, 539, 543, 545, 621,625 and 633. [419] The term 'officer' since excluded auditors from its definition.

Section 628 of the Companies Act states, if in any report, certificate, balance-sheet, prospectus, statement or other document required by this Act, makes a statement (a) which is false in any material particular, knowing it to be false or (b) omits any material fact, knowing it to be material, the punishment on conviction is imprisonment for a term which may extend to two years and shall also be liable to fine."

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[417] G.B. Yankwitt and S.A. Moldovan, "Reform Act: Panacea or Paper Tiger for Accountants and Auditors?", 6 (1) *New York Law Journal* (1996) at 1, (citing private litigation under the Federal Securities Laws) Lambert quotes a figure of 12 % in : R. Lambert, "Law Note", *Wall street Journal* 10, B5

[418] J.D. Glater, "Auditor to Pay $217 Million to Settle Suits", New York Times, Mar.2, 2002, at C1. also see C. Aldred, "Auditors' E&O Costs Add Up", Business Interest., Feb. 4, 2002, at 3 and 32 W. Greider, *Crime in the Suites*, The Nation, Feb. 4, 2002, at 11, 12. and at 32.

[419] Prior to the amendment in 2000, An auditor was treated as an office in default only for certain Sections this has been deleted now.

Section 233 of the act prescribes penalties for the auditors for not complying with the provisions relating to the audit of the accounts. If the auditor wilfully defaults while performing his duties the fine that is payable is rupees ten thousand. Further, under Section 62, the Companies Act, an auditor shall be held liable to compensate every person who subscribes for any shares or debentures of a company on the basis of a prospectus containing an untrue statement made by him as an expert. Like in USA, class action suits are difficult to follow and the legal proceeding against an auditor is not taken for fraudulent financial reporting in the annual report in India.

Liability for Professional misconduct.

Under the Charted Accountants Act, an auditor may face action for professional misconduct. The ICAI has power to discipline its members under the disciplinary action of the Chartered Accountants Act. Section 27 of the Chartered Accountants Act defines and elaborates 'professional misconduct.' In case of misconduct the disciplinary committee sets up an inquiry committee for such cases. Some times these may be taken up to the court. The auditor is also liable as per Clause 5 of the Code of Conduct[420], if he does not disclose a material fact know to him which is not disclosed in a financial statement, but the disclosure of which is necessary to make the statements not misleading. However, this liability arises only when the auditor has the knowledge of the fact. These facts are to be brought to the notice of the shareholders to whom their reports are addressed. In addition to this the auditor has also to report on any material misstatements of facts that appear in the financial statements. The auditor and the Directors and other officers who are responsible for fraudulent financial reporting must be penalised with high fines and disqualification.

In the JPC report, the auditors of foreign banks were faulted for not pointing out the various violations of RBI guidelines and irregularities committed by those banks. Such observations were already pointed out by certain reports made by RBI on those banks. This omission by the auditors led to a situation where the accounts prepared by them did not portray a true and fair view of the financial situation. The JPC expressed shock that the auditors who had failed in their responsibilities even during the scam of 1991 were not disciplined by the

ICAI or the DCA. The auditor's liability in the case of fraudulent reporting is very limited. The examination of the disciplinary cases instituted by ICAI has very few instances of disciplining the erring auditor for accounting and misreporting.[421]

Third Party Liability

The auditor of a company is appointed by the shareholders and is liable to them in the first instance. The liability is to the shareholders as a group and not to the individual shareholder.[422] The auditors' liability to third parties who rely on the financial statement for their decision-making has generally not been accepted in many courts. For example potential shareholders cannot claim any duty of care by the auditors.[423] It is also recognised that an action for negligence can be brought about against the auditor in a tort by a person with whom the auditor is not in contractual relation ship but to whom he owes a duty.[424] For example in the Scottish Court of Session had to decide on the duty of care of an auditor to a bank in Royal Bank of Scotland plc v Bannermann Johnstone Maclay (the firm) and Others. The bank had advanced monies to a company forming a judgment on the basis of the audited financial statements given by the firm. The company later was wound up and the bank had to appoint a receiver on account of which it suffered a loss, which it wanted to recover from the auditor. The auditors defended themselves saying that they did not owe a duty of care to the bank since the axioms laid down in Galoo Ltd v Bright Grahame Murray and Another (1994 1 WLR 1360) suggesting that in addition to knowledge of the user of the accounts there was a further requirement that the auditors must intend that the claimant should rely on the accounts was not satisfied in the instant case. They argued that the only intention they had was to

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[420] ICAI, *Code of Conduct* 8 (New Delhi: ICAI, 1988)

[421] The Joint Parliament committee faulted the auditors of foreign banks for not pointing out the various violations of RBI guidelines and irregularities committed by those banks. Such observations were already pointed out by certain reports made by RBI on those banks. This omission by the auditors thus led to a situation where the accounts prepared by them did not portray a true and fair view of the financial situation. Report of the Joint Parliament Committee on the stock market scam and matters relating thereto 2002 at http://164.100.24.208/ls/committee/report.htm (Mar 12, 03)

[422] Caparo Industries PLC v. Dickman and Others. 1990. 1 All ER 568

[423] Courts in UK and in some cases in the US have not accepted the duty of care to parties other than the shareholders eg: see Capro v. Dickman and others 1 All ER, 568, 1990; James McNAughton Paper Group v. Hicks Andersen & Co, 1991 1 All ER 134

[424] R. S. Waldron,*Dicksee's Auditing* (London : Gee and Co, 1969) at 1058-1066

carry out their duties under the Companies Act to audit the accounts. While the auditor owed a duty of care, the bank failed to prove that the audited accounts were prepared negligently and hence no liability arose. Many a times auditors also accept letters from the management and perceive that there are no liabilities. In the recent years the number of third party law suits in the US and UK have been increasing.[425]

Auditors Liability in other countries

In the UK, the Companies Act governs the provisions relating to auditors' apart from the professional organisation. The Companies Act does not deal with negligence and liability of an auditor. The courts decide on a case-to-case basis to decide if there has been breach of duty of care.

The role of auditors as an institution functions very conservatively in Germany. Here auditors' responsibility for reporting is to the supervisory Board and not shareholders as in Anglo American traditions. The auditor's liability is set in the Section 323 HGB. The liability extends to the assistants and also the legal representatives of the audit forms. Germany has a conservative body of law in this regard as statutory law allows recovery only if the statutory auditor acted intentionally or with reckless disregard of the truth. The law clearly states that the audited corporation and associated enterprises are entitled to sue the auditor for damages, and makes it clear that, shareholders and creditors are not in a position of privity.[426]In contrast to the Anglo-American system, the supervisory Board looks into the interests of shareholders and the auditors report to the supervisory Board. There is also a view that German auditors have had a relatively restricted or a conservative reporting role, which is also supported by consideration of the details of legislation concerning auditor responsibilities. A unique provision in the law is a limitation or cap on the maximum amount of liability that an auditor can be sued for negligence. These limits do not apply for

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[425] C. R. Baker, "A Comparison Of Auditors' Legal Liability In the United States and in Select European Countries", panopticon.csustan.edu/cpa96/pdf/baker.pdf (Aug 03,2003) See cases Royal Bank of Scotland plc v Bannermann Johnstone Maclay and Others (Times Law Reports 2002, Galoo Ltd vs Bright Grahame Murray and another 1 WLR 1360 1994;

[426]Quoting W.F. Ebke and Struckmeier, "The Civil Liability of Corporate Auditors: An International Perspective", 27 (1994) in M.B. Gietzmann and R. Quick, "Capping Auditor Liability: the German Experience", 23 (1) *Accounting, Organizations and Society* 81-103 (1998)

intentional acts of the auditors. The auditor is liable to third parties when there is an intentional violation of law causing damage to the third party. In the US the auditor has to report on any illegal acts by the company. If the company's authorities do not take action then the auditor has to report to the SEC. Section 10A grants an accounting firm a safe harbour from liability in a private action for reporting to the SEC, but the accounting firm's failure to furnish its report to the SEC may subject it to civil penalties. The recent Sarbanes Oxley Act prescribes heavy penalty for untrue statements.

To conclude, there are enough provisions in the Companies Act, both civil and criminal, for auditor's liability and for investor protection. However, the lengthy court proceedings and laxity resulted in auditors not being sued even in cases in which their actions have demonstrably resulted in losses to companies and/or their investors. The auditor's liability in the case of fraudulent reporting is very limited. The examination of the disciplinary cases instituted by ICAI has very few instances of disciplining the erring auditor for accounting and misreporting.[427]

Shareholders class action lawsuits can act as a deterrent as the firms would want to maintain their reputation. Litigation against auditors can help identify potential audit failures and poor quality audits.[428] Class Action suits are common in the US and if they are not class action suits then an auditor can be sued under the state law. The Auditors now also have an obligation to whistle blow on their clients.[429] This represents a significant departure from existing judicial and professional auditing standards in terms of auditors' potential fraud liability. The liability of the Indian auditors is not as stringent as in the US. The problem of auditor's independence will continue to exist as long as the fees are received from the companies and the auditors perceive their clients as the management (promoters) or the Board of Directors. The role of auditors in detecting frauds is limited.

[427] Noted from: ICAI *Disciplinary Cases Hand Book, (*New Delhi: ICAI, 1997)

[428] Z.Palmrose, "An Analysis of Auditor Litigation and Audit Service Quality", 63(1) *The Accounting Review* 55-73 (1988)

[429] Because of this big auditors firms have not continued with the audit assignments of many clients.

6.4 Other Institutions

6.4.1 Accounting Profession as a Self Regulatory Organisation

Regulation is important for the proper development of the securities market, however not all aspects can be regulated. A flexible mechanism for controlling and regulating the participants' activities at all levels of the market is needed like a self-regulatory organisations. Any organisation, which undertakes to enforce regulations on its members, within a framework of regulation set out by a regulatory body, can be called as a Self Regulatory Organisation (SRO). SROs can be developed in the system with the help of market participants to help the main regulator in creating better and effective capital markets. Having SROs may contribute to the quality of regulation and to the content of policy in the public interest.

In the capital market, IOSCO defines self-regulation as "a unique combination of private interests with government oversight, in an effective and efficient form of regulation for the complex, dynamic and ever-changing financial services industry."[430]

SROs are created by professional securities market participants with the aim of developing and controlling professional ethics standards, protecting the interests of the shareholders and other participants in the capital market by establishing rules and standards on dealing securities, maintaining the balance of interests among securities market participants, and ensuring a level of trust and interest between investors and issuers. In the US, the Securities Exchange Commission is the primary authority for regulating the securities market. The SEC has delegated significant portion of its authority to SROs. These include the New York Stock Exchange and National Association of Securities Dealers. Accounting and audit are of central importance for the proper functioning of capital markets. While the government is interested in the credibility and stability of financial markets, the responsibility for regulating the accounting profession - including the training, certification and licensing of auditors, and the monitoring of the profession tends to be delegated to professional associations that function as

self-regulatory bodies. SROs can play an important role in reducing the information asymmetry in the markets and also disciplining the erring members to the extent of barring them from the membership.

The development of technical standards for financial accounting and audit also require the expert input of the professional bodies. The professional institutes generally take up these activities. The ICAI and the AICPA are self-regulatory organisations. These organisations initiate active measures for regulating the profession and the conduct of the members. The ICAI issues the accounting standards and also regulates the matters relating to audits. The AICPA in the US does not pronounce the accounting standards, which is done by FASB, but issues general-purpose accounting statements of position (SOP) and additionally also focuses on industry-specific accounting and auditing guidelines. The AICPA also conducts investigations and imposes disciplinary actions on accountants who commit fraud or otherwise violate the code of conduct. In UK too, a professional body regulates the working of accountants.

The role of these self-regulatory organisations will be limited if they do not have adequate powers and recognition. Self-regulation has always been subject to public criticism. Given that SROs are run for the benefit of their members, there are concerns that SROs have inadequate incentives to enforce rules that protect the public.[431] For this, government oversight of self-regulation can benefit people by leading the SRO to a more forceful enforcement. The SRO would choose an enforcement policy that is just aggressive enough to pre-empt the government from doing its own enforcement. An example of this response is with regard to auditor independence. In the US prior to Sarbanes – Oxley Act, 2002 the audit profession was regulated through a self-regulatory body whose mechanism was through a system of peer review. This body was subject to oversight by an independent private sector body called the Public Oversight Board. Due to concerns of conflicts of interest, the SEC has proposed rules to limit the consulting services that auditors can provide for clients and has proposed the establishment of a statutory regulator. In response, the AICPA

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[430] Report of the SRO Consultative Committee of the International Organization of Securities Commissions, May 2000 at www.iosco.org (Dec 03, 2001)

[431] B. S. Black argues that low quality intermediaries can form lax SRO in B. Black, "Legal and Institutional preconditions for a strong securities markets", 48 (4) *UCLA Law Review* 798 (2001)

established a new charter for its regulatory arm, the Public Oversight Board (POB).[432] Thus to succeed as a good self-regulatory organisation, the enforcement by the SROs and the regulatory supervision on these bodies are essential. It is suggested that the ICAI take more active role in disclosure practices and giving guidelines on certain non-financial information. It is also recommended that ICAI take action on erring members involved in fraudulent financial reporting.

6.4.2 Stock exchanges

In line with the global trends of capital markets with regard to disclosure-based screening for listing securities on the Exchange, a key goal of any Stock Exchange would be to develop a 'well-informed' market by ensuring full disclosure of important information deemed relevant to investor's decision-making. This will ensure that investors are well placed to assess, and protect their own interests in the market.

Companies listed on any Stock Exchange have greater disclosure obligation. Apart from the annual report filings the Stock exchanges may direct companies to disclose additional price sensitive and other information. Stock exchanges are also directed by regulatory authorities to review the listing requirements and included corporate governance related procedures and disclosures. These disclosures are designed to ensure a fair securities market, in which all market participants have simultaneous access to the same information.

The stock exchanges are a self-regulatory body and would formulate rules for its member participants. For example, NYSE appointed a Corporate Accountability and Listing Standards Committee to review the NYSE's listing standards, along with recent proposals for reform, with the goal of enhancing the accountability, integrity and transparency of the Exchange's listed companies.

At present stock exchanges in India have delisted vanishing companies causing hardship to investors. Similarly, violators of the listing agreement have been shifted to Z category. Shareholders in such cases have been left with worthless shares with no exit route causing a lot of hardship. It is suggested that

[432] The new charter strengthens and broadens the POB's regulatory power

exchanges install a signalling system that can identify the type of violators like those relating to non-compliance of the listing agreement, companies with poor performance on certain criteria or those under government investigations or other irregularities.

Stock exchanges can also play an active role in educating the investors. In the US, the SEC's Office of Investor Education and Assistance provides a variety of services to address the problems and questions of an investor so that investors can invest intelligently.

6.4.3 International organisations

International organisations such as OECD, World Bank and IOSCO play an important role in ensuring the transparency and good corporate governance of member countries. The World Bank and bilateral donors have placed transparency and governance at the heart of their development agenda because it relates to the government's ability to create a more open and flexible society that gives voice to the people and benefits all. The OECD Principles and their implementation, both in member and non-member economies are areas of corporate activities. The integrity of corporations, financial institutions and markets is central to an economy and its stability. The OECD Steering Group on Corporate Governance co-ordinates and guides the Organisation's work on corporate governance. OECD has prepared a document titled 'Principles of Corporate Governance' which includes certain principles on disclosures and transparency. These are given in Table 6.1

An international body gaining importance is the Financial Stability Forum (FSF) that was convened in April 1999 to promote international financial stability through information exchange and international co-operation in financial supervision and surveillance.[433] Apart from other areas, the forum has identified 12 standards in different areas for the development of a sound financial system. While the key standards vary in terms of their degree of international endorsement, they are broadly accepted as representing minimum requirements for good practice. Some of the key standards are relevant for more than one policy area, e.g. sections of the Code of Good Practices on Transparency in

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http://www.publicoversightboard.org/charter.htm (Dec 02, 02)
[433] http://www.fsforum.org/home/home.html

Monetary and Financial Policies have relevance for aspects of payment and settlement as well as financial regulation and supervision. Table 6.2 gives the 12 standard areas for development by different authorities.

6.4.4 Role of Governance Institutions in disclosures

While the mandatory and legal environment are necessary for effective disclosures, high standards of disclosures can be achieved only by voluntary disclosures that can be affected through various governance mechanisms. Any regulatory or other system depends upon the competence and integrity of corporate Directors, as it is their responsibility to diligently oversee management while adhering to ethical standards. The Directors, especially the independent Directors have an important role to play in monitoring the companies.

Independent Director or the non-executive Director is expected to perform the role of a "watch dog" on behalf of the shareholders.[434] These Directors are not executives of the company and are free from any business or other relationship, which could interfere with the independent judgement of a situation. They have an important role to play in the formulation of strategies, oversight of the management, in the disclosures made and above all protecting the interest of all the shareholders.

The monitoring role of independent Directors may be ineffective due to lack of supply of qualified Directors. Their monitoring role will be more pronounced, as the controlling owners will hire these Directors who may then see themselves as working for the controlling owners. These problems must be addressed for an efficient functioning of the independent Directors.

Audit Committees

The audit committee of the Board of Directors generally comprises of the independent Directors with financial, auditing, company, and industry expertise. The audit committee of the Board of Directors is considered to be the most important part of the Board as they have great responsibilities. Two of the important responsibilities are a) to provide diligent oversight of the financial reporting process and the b) the role in selecting the external auditor and

[434] N. Balasubramanian, *Creating an effective board* (N. Balasubramanian and Malaysian Insurance institute in Corporate Board and Governance eds., Kuala Lumpur: Malaysian Insurance Institute) at 32

evaluating external and internal auditor performance, and approve the audit fee. The independent Directors and the Audit Committees have an important role to play in the disclosure environment of a firm.

Institutional Investors

Several reports on corporate governance have emphasised the role that the institutional investors can play in the entire system. The Cadbury committee report, for example, states that "because of their collective stake, we look to the institutions in particular, with the backing of the Institutional Shareholders' Committee, to use their influence as owners to ensure that the companies in which they have invested comply with the code"[435]

In India, the Confederation of Indian Industries (CII) report on corporate governance has also brought out the role that the institutional investors can play in the corporate governance of a company. The Kumarmangalam Birla committee on corporate governance (henceforth SEBI committee) similarly emphasises the role that the institutional shareholders can play in the corporate governance system of a company. Different institutions, like the pension funds or the foreign financial institutions or the domestic institutional investor or mutual funds may have different effects on a firms activities and disclosure patterns. The results in the Chapter 5 showed that foreign institutional investors had a positive impact on the disclosure levels of a company. Indian financial institutions have been passive investors so far, unless there was a major issue. Most of the agency related and disclosure problems can be reduced if these investors are active monitors.

6.5 Chapter summary

Institutions play a very important role in the disclosures environment of the company. At the minimum, institutions ensure that the mandatory or minimum legal disclosures are complied with. Institutions that are involved in the corporate disclosure environment are the standard setting bodies, enforcement systems, the statutory auditors and other institutions.

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[435] Supra note 22 at para 6.16

The standard setting institutions are important as they have to fulfil the role of setting standards that are clear and unambiguous and are not influenced by any group or interested bodies. The standard setting process should be transparent and a participative one with dissemination of information to all concerned. The Indian standard setting process has to be more transparent and open for discussion as also suggested in the standard setting process by IAS. The enforcement systems enforcing disclosure regulations are weak and a strong body like the SEC in the US or the FRRP in the UK must be set up to oversee the financial reporting.

The regulator should have comprehensive enforcement powers and the regulatory system should ensure an effective and credible use of inspection, investigation, surveillance and enforcement powers and implementation of an effective compliance program. The Serious Fraud Office set up by the DCA and other initiatives by SEBI are a right move in this direction. The action initiated against wrong doers must be swift. The functioning of the legal system especially the judicial system is very important for investor protection. The law must punish the wrong doers swiftly to be effective.

Auditors provide credibility to the accounting information. For a healthy investment climate apart from disclosures the overall legal environment plays a major role in the proper functioning of the capital market. Shleifer and Vishny argue that the legal protection is essential if outside investors are to provide finance to companies. The current securities and company legislation, and the general legal framework can accord adequate protection to minority shareholders. In the absence of effective enforcement and protection to minority holders, ownership may remain concentrated with significant ownership by promoters, which go against the separation of decision management and decision control and leads to the inefficient sharing of risks.

In the absence of threat of takeover the role of regulatory institutions become more important for the effective functioning of the capital market. Mechanisms to punish the defaulters and the threat of class action suits may act as a disciplining tool to the erring management and owners as well as auditors. Governance institutions play an important role in the voluntary disclosure environment. Strengthening of the certain governance mechanism like the

independent Directors and the audit committee will pay a crucial role in the disclosure practices of a company.

As we shift towards a disclosure-based system, which emphasises greater disclosure and shareholder monitoring, significant changes have to be made in the corporate governance environment. As discussed above, this will require significant changes in the way accounting standards are set and accounting rules enforced (including the need for a strong independent accounting body), stronger securities regulations and enforcement and greater shareholder activism, especially by institutional investors.

Table 6.1: Disclosure and Transparency Principles: OECD[436]

The corporate governance framework should ensure that timely and accurate disclosure is made on all material matters regarding the corporation, including the financial situation, performance, ownership, and governance of the company.

A. Disclosure should include, but not be limited to, material information on:
1. The financial and operating results of the company.
2. Company objectives.
3. Major share ownership and voting rights.
4. Remuneration policy for members of the Board and key executives, and information about Board members, including their qualifications, the selection process, other company Directorships and whether they are regarded as independent by the Board.
5. Related party transactions.
6. Foreseeable risk factors.
7. Issues regarding employees and other stakeholders.
8. Governance structures and policies, in particular, the content of any corporate governance code or policy and the process by which it is implemented.

B. Information should be prepared and disclosed in accordance with high quality standards of accounting and financial and non-financial disclosure.

C. An annual audit should be conducted by an independent, competent and qualified, auditor in order to provide an external and objective assurance to the Board and shareholders that the financial statements fairly represent the financial position and performance of the company in all material respects.

D. External auditors should be accountable to the shareholders and owe a duty to the company to exercise due professional care in the conduct of the audit.

E. Channels for disseminating information should provide for equal, timely and cost-efficient access to relevant information by users.

F. The corporate governance framework should be complemented by an effective approach that addresses and promotes the provision of analysis or advice by analysts, brokers, rating agencies and others, that is relevant to decisions by investors, free from material conflicts of interest that might compromise the integrity of their analysis or advice.

[436] OECD, "OECD Principles on Corporate Governance" at www.oecd.org (Dec 12, 03)

Table 6.2: Standard Setting Bodies Around the World

Area	Standard	Issuing Body
	Macroeconomic Policy and Data Transparency	
Monetary and financial policy transparency	Code of Good Practices on Transparency in Monetary and Financial Policies	International Monetary Fund
Fiscal policy transparency	Code of Good Practices in Fiscal Transparency	International Monetary Fund
Data dissemination	Special Data Dissemination Standard/ General Data Dissemination System	IMF
	Institutional and Market Infrastructure/ Insolvency	World Bank
Corporate governance	Principles of Corporate Governance	Organisation for Economic Co-operation and Development.
Accounting	International Accounting Standards	International Accounting Standards Board
Auditing	International Standards on Auditing	International Federation of Accountants
Payment and settlement	Core Principles for Systemically Important Payment Systems Recommendations for Securities settlement Systems	Committee on Payment and Settlement Systems
	Financial Regulation and Supervision	
Banking supervision	Core Principles for Effective Banking Supervision	Basel Committee on Banking Supervision
Securities regulation	Objectives and Principles of Securities Regulation	International Organisation of Securities Commission
Insurance supervision	Insurance Core Principles	International Association of Insurance Supervisors

Table 6.3: Summary of the provisions relating to auditors in the Sarbanes Oxley Act, 2002

- Prohibits an auditor from performing specified non-audit services contemporaneously with an audit. Allows the audit committee to approve some activities for non-audit services that are not expressly forbidden by the Act.
- Prohibits an audit partner from being the lead or reviewing auditor for more then five consecutive years (auditor rotation).
- Requires that auditors report to the audit committee ON:
  - Critical accounting policies and practices used in the audit
  - Alternative treatments and their ramifications within GAAP
  - Material written communications between the auditor and senior management of the issuer
- Places a one year prohibition on auditor performing audit services if the issuer's senior executives had been employed by that auditor and had participated in the audit of the issuer during the one year period preceding the audit initiation date.
- Encourages State regulatory authorities to make independent determinations on the standards for supervising non-registered public accounting firms and consider the size and nature of their clients' businesses audit.
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- Establishes a five member Public Company Accounting Oversight Board (with general oversight by the SEC) to:
  - Oversee the audit of public companies
  - Establish audit report standards and rules
  - Inspect, investigate and enforce compliance on the part of registered public accounting firms and those associated with the firms