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REDEFINING CORPORATE GOVERNANCE THROUGH STATUTORY AUDITORS: UNPACKING REFORMS, IMPACT AND SUSTAINABILITY

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ABSTRACT

The scope of financial corporate scandals has evolved parallel with the evolution of auditing practices. These scams have the capacity to cause turbulence in the global economy beyond imagination. The principles of Corporate Governance were introduced for deterring such scams by raising the standards of financial accountability. To prevent such probable scams, the regulators need the assistance of the Statutory Auditors. They act as the forebearers in achieving the standards of financial accountability as per the best practices of corporate governance.

The idea behind choosing this topic for the article was to evaluate the viability of the developments in regulations regarding the statutory auditors in the backdrop of their practical implications. We analysed that these reforms are not reformative in the true sense as they have a counter-effect of burdening the auditing professionals with added risks and responsibilities. The purpose of this article is to look at these reforms from not only the angle of financial accountability but also that of corporate governance and thereby find ways to mitigate the hassles for auditors while enhancing accountability simultaneously.

The article starts with introducing its main concepts- Statutory Auditors, Financial Accountability and Corporate Governance, and establishing a nexus between them. We then move on to explaining the evolution of the regulations concerning them and highlighting the recent developments in this regime and the objectives sought by such developments. The

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authors then critically evaluate the implications of such stricter, enhanced regimes on the auditors and the resultant challenges. Finally, the article progresses to suggest the way forward wherein the authors conclude by carving out the need to balance the scales and mitigate some of the obstacles that the statutory auditors are facing today in a bid to instil the ideals of corporate governance and increase the efficacy of accountability and 'good auditing.'

Keywords: Statutory Auditor, Corporate Governance, reforms, sustainability, auditing profession, role of auditors.

INTRODUCTION

In the contemporary world where information acts not only as currency but also a basic input of governance, the very idea of a Corporate Entity demands a free flow of accurate information from the agent to the principal- from the Directors discharging their fiduciary duties to the capital-investing Shareholders. Broadly speaking, the effectiveness of external corporate governance mechanisms relies on the presence of accurate information, which is crucial for determining various corporate facets such as the market for corporate control, capital market efficiency in allocating external finance, the workings of the managerial labor market, and the determination of managerial compensation[2]. Moreover, the release of appropriate and adequate data helps in an analysis of the company's operations by external investors and analysts, while simultaneously guaranteeing that the company leverages the limited resources of its owners for maximum productivity. Information is thus an essential element of corporate governance since it permits both direct and indirect oversight of business management by both insiders and outsiders.

This constant requirement of information is fulfilled through trustworthy and thorough financial reporting. Allthe above-mentioned operations and processes that run parallel and complimentary to a healthy corporate environment, engaging stakeholders other than its equity shareholders and management, require information of the company's performance in the form of its verified balance sheets, income statements, statements of retained earnings,

[2] JAYATI SARKAR & SUBRATA SARKAR, CORPORATE GOVERNANCE IN INDIA 363 (Sage Publications 2012).

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and cash flow statements to ensure their interests are being or would be catered to. Here we are introduced to the 'Gatekeepers'[3] of corporate governance- Statutory Auditors.

External auditors and audit committees are considered crucial governance structures that are specifically designed to guarantee that an enterprise generates relevant, sufficient, and reliable information. As often mandated by statutes of various jurisdictions around the world, statutory (external) auditors, working alongside the audit committee, ensure the accuracy and reliability of the information generated. Why are statutory auditors required for this verification? By common logic, audit quality is commonly understood to be comprised of two key components[4]: the auditor's proficiency in carrying out an audit and the auditor's inclination to disclose any unfavourable findings regarding a company's financial statements, if necessary. The first is regulated by maintaining varied standards on auditing through minimum requirements of qualification and notifying compulsory standards to be conformed with. The latter, however, demands a nuanced framework on what is considered the key concept in auditing governance- independence of auditors. If there is any reason for an auditor to not disclose misconduct or fraudulent behaviour due to conflict of interest, the auditing reports cannot be trusted, transparency cannot be maintained in the true sense and the whole purpose of auditing falls to its knees. An internal auditor employed by the company, deriving their salary as an employee of the company cannot truly have any reason besides an ethical calling to play the role of a whistle-blower. Thus, a variety of provisions are put in place to ensure the independence of statutory auditors from the companies to ensure proper financial reporting.

The first part of this article discusses into the intricacies surrounding financial reporting and corporate governance, highlighting the necessity of Statutory Auditors. In this context, apart from basic reasoning, we delve into the economic theory and concession theory of corporations to offer different viewpoints that support a mandate for statutory auditors. Furthermore, the link between corporate governance, statutory auditors and financial reporting is outlined and bolstered. The second part of the article traces the evolution of statutory auditors through the decades, the changes in expectations of financial reporting standards that resulted therewith and discusses the current national and international regimes

[3]J.C. COFFEE, GATEKEEPERS (Oxford University Press 2006)
[4]ANDREA MENNICKEN ET.AL., THE OXFORD HANDBOOK OF CORPORATE GOVERNANCE 316 (Oxford University Press 2014).

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that govern auditing. This part also sheds light on how increasingly substantial auditor independence manifested with corporate scams acting as catalysts by exposing loopholes in pre-existing regulations. The subsequent section of the article proceeds to discuss the demand for stricter regulations imposed on auditors. It is of great importance that we understand what attempts are being made to further raise the bar for statutory auditors and what objectives they wish to pursue with such attempts. The final section of this article focuses on assessing these very reformative measures and revised policies to analyse the impact they have on the auditing profession and corporate governance. Additionally, it explores the potential challenges that may arise when implementing more rigorous auditing systems. The article further attempts to outline a sustainable and viable way to improve efficiency of auditing and corporate governance in India and concludes by envisaging a way forward in the field.

Statutory Auditor- Nexus of Corporate Governance and Financial Reporting

As stated in the introduction, auditing is a system put in place to handle agency problems in corporations in order to improve the evaluation of resource utilization and output generation through corporate operations. Considering the dynamics involved in both internal and external auditing, a good question to ask would be what role statutory auditors play in ensuring not only accountability of the companies to the public, but also the trustworthiness of the financial accounts produced by it. There are a few rationales and justifications for statutorily mandating the auditing procedure found in both common logic and various theories of corporate analysis. As discussed in the introduction, a clear, transparent and unbiased review of the company cannot be expected out of any auditor employed by the company itself. Even if statutory obligations are imposed, there is a clear incentive for internal auditors to report biased views and enable corporate scams to reap personal benefits while hiding misconduct. Thus, statutory auditors are required as the last line of defence, the watchdogs verifying financial statements in consonance with evidence backing the same. Other theoretical justifications for statutory auditors are discussed below:

A. Economic Theory Rationale

The economic analysis of corporate law aims to evaluate the advantages of conducting business through a corporate entity compared to alternative legal forms of business

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organizations, by examining their nature and origins. Another approach adopted by this theory is to consider the advantages and disadvantages- the 'costs' and 'benefits', of certain corporate law mandates that are already in place or being proposed worldwide[5].

Regarding the field of auditing, the latter approach emphasizes the importance of audits in cultivating confidence and facilitating investors' ability to make logical and well-informed financial choices. The process of conducting audits serves to improve the reliability and inherent worth of financial accounts, hence increasing their dependability. This, in turn, enhances shareholders' trust and contributes to the efficient operation of capital markets.[6]. The statutory auditing requirement thus strengthens these elements that enhance trustworthiness and add quality, as it involves an external party that can independently verify a company's financial information. Theoretically speaking, this practice decreases the expenses, or 'cost' that individuals who utilize that information would otherwise have to bear if they were required to authenticate it independently. Therefore, Statutory auditors play a crucial role as "reputational intermediaries"[7] by aiding in the smooth functioning of the corporate information market, the capital market and by extension- the whole of corporate ecosystem.

The aforementioned policy was outlined by Street CJ in Eq in *re Castlereagh Securities Ltd*as follows:

“A sound share market and the ability of shareholders to reach reliable conclusions are dependent upon shareholders, brokers and financial experts having access to full and reliable information concerning the affairs of companies…It is the clearly discernible intention of the companys’ legislation that companies should make adequate disclosures to enable shareholders individually, and the market collectively, to reach informed judgments. Where authentic details are not forthcoming, inference and even speculation inevitably take over. Decisions based on gossip or on inside information are concomitants of an unhealthy market.”[8]

B. CONCESSION THEORY RATIONALE

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[5] DavidGindis& Martin Petrin, *Economic Analysis of Corporate Law,* SSRN(Apr. 30, 2020), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3576513.
[6] STEPHEN BOTTOMLEY, ETHICS AND AUDITING 5 (ANU Press 2005).
[7] *Id.*
[8] In Re Castlereagh Securities Ltd, [1973] 1 NSWLR 624, p. 638.

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The Concession theory of corporate personality offers an alternate justification for statutorily mandating auditing procedures. Essentially, the theory supports the idea that a corporation is but an artificial creature without any existence until it is given an independent legal status by the State- creating a private entity with rights and powers for the benefit of the public[9]. It is also argued that this particular status has certain obligations. Accordingly, the condition that a corporation must regularly disclose its financial reports to the public and undergo an audit, acts as a "quid pro quo for granting of incorporation by the State"[10], whose main objective is to ensure the welfare of the masses.

According to this perspective, when an auditor gets appointed to fulfil the corporation's legal obligation for an audit, they can be considered to be carrying out a two-fold role. The initial function can be characterized as "private"- attributed to the contractual bond established between the auditor and the company. The primary obligation of an auditor under this contract is to apply a reasonable level of expertise and diligence when performing an audit. If these duties are breached, the company may take legal action to seek damages from the auditor. Additionally, there exists the auditor's second function that is more oriented towards the general public. Usually, regulatory legislations mandate that an auditor must provide a report to the company regarding its financial statements, and this report should also be made available to the public as part of the official records. Moreover, while carrying out the audit and presenting reports to the company, the auditor must adhere to numerous legal obligations that cannot be modified via contractual agreements. It is important to note that these obligations consist of the act of notifying the relevant regulatory body in the event that the auditor suspects any violation of the legislation. In this respect, the audit is a part of a wider public system of corporate regulation. There is undoubtedly a tension between these private and public duties, which is especially evident when one considers the question of an auditor's responsibility to groups outside of the contractual relationship- the general public. Again, this conflict is resolved with the mandate of statutory auditors.

C. CORPORATE GOVERNANCE IDEALS IN FINANCIAL REPORTING

[9] Hale v. Henkel, 201 U.S. 43, 74 (1906).
[10] Robert Hessen, *A New Chapter of Corporations: A Contractual and Private Property Model,* 30 HASTINGS LAW JOURNAL 1327, 1327-1331 (1979).

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One of the key facets of good corporate governance demands transparency. The corporate structure exists on the very ground of a principal-agent relation and hence transparency is of utmost importance. As explained above, various theories justify the existence of a statutory auditor on account of trust, cost-benefit ratio and even responsibility to the sovereign. However, the contemporary world demands the existence of a robust auditing mechanism on account of corporate governance practices that hold much sentiment and respect of not only authorities but also the general public.

The Organisation for Economic Co-operation and Development (OECD), an international organisation consisting of 38 Member nations[11], established with the sole aim of promoting economic development and encouraging world trade, is one of the fore-runners in drafting policies and recommendations for good corporate governance practices all over the world since 1961[12]. The OECD's Council recommendations on the Principle of Corporate Governance categorically state "Well-designed corporate governance policies provide a framework to protect investors, which include households with invested savings. A formal structure of procedures that promotes the transparency and accountability of board members and executives to shareholders helps to build trust in markets, thereby supporting corporations' access to finance. A substantial part of the general public invests in public equity markets, either directly as retail investors or indirectly through pension and investment funds. Providing them with a system in which they can share in corporate value creation, knowing their rights are protected, will give households access to investment opportunities that may help them to achieve higher returns."[13]

The above principle visualizes a system of corporate governance where companies are financially accountable to the public. This requirement manifests itself in the need for statutorily mandated audits, by auditors not involved in company affairs to avoid conflict of interest, biased clearances and abuse. The primary objective of the statutory audit thus becomes assessing the extent to which a company is presenting a reliable and truthful depiction of its financial position, from the perspective of an independent auditor.

[11]OECD,https://www.oecd.org/about/document/ratification-oecd-convention.htm4 (last visited Aug. 15, 2023).
[12]OECD,https://www.oecd.org/about/ (last visited Aug. 15, 2023).
[13]OECD LEGAL INSTRUMENTS,https://legalinstruments.oecd.org/en/instruments/OECD-LEGAL-0413 (last visited Aug. 15, 2023).

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The Naresh Chandra Committee (NCC) rightly pointed out two key principles that form the foundation of an auditor's independence. The first principle is independence of "mind", which allows auditors to form unbiased and well-reasoned opinions without being influenced by any factors that could undermine their integrity, professional scepticism, and objective judgment. The second principle is independence in "appearance", which necessitates avoiding any situations or circumstances where a knowledgeable external party would reasonably deduce that the auditor's honesty, objectivity, and professionalism could have been undermined. As the NCC rightly points out "for the public to have confidence in the quality of audit, auditors must always be - and be seen to be - independent of the companies that they are auditing."[14]

Therefore, in instances where potential conflicts may arise, the law typically adopts a sceptical stance and prioritizes the welfare of the general public over that of the auditor or the company. It is in these ways that statutory auditors themselves become the cross-roads of accountability in financial reporting (to the public) and good corporate governance practices that build transparent companies and economies- limiting abuse of loopholes, dishonest practices and public loss.

III. Evolution of the Statutory Auditor

The crucial role of the free flow of accurate information between a company and its stakeholders for accountability and incorporating principles of Corporate Governance is undisputed. The previous part of this article has shed some light on this important nexus. But how this nexus came to be realised in the form of the existence of 'statutory' auditors is an important question. As has been rightly put forth by Flint, "It (auditing) is an evolving process, reacting with changing expectations about the performance or conduct of the individuals or organisations to which it is applied."[15]

A. Origin & Development of Statutory AuditingPrinciples in the 19th Century

Auditing firm reports was once optional but became mandated in the 19th and 20th centuries. Early auditing originated from The English East India Company. The British corporation

[14] Jayati Sarkar & Subrata Sarkar, *Auditor and Audit Committee Independence in India,* Indira Gandhi Institute of Development Research, Mumbai, (Aug. 15, 2023, 8:00 PM), http://www.igidr.ac.in/pdf/publication/WP-2010-020.pdf.
[15] Andrea, *supra* note 3, at 308.

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adopted a sophisticated auditing system and switched from ex-ante to ex-post auditing in its first 40 years as its business and financial activities increased[16]. Later,the Joint Stock Companies Act, 1844, the first UK company incorporation law, mandated compulsory financial reporting[17]. The 1844 act was based on a Select Committee report that stated, "Periodical accounts, if honestly made and fairly audited, cannot fail to excite attention to the real state of a concern and... parties to mismanagement may be made more amenable for acts of fraud and illegality."[18]

Unfortunately, the act's efficacy was hampered by the statutory auditors' incompetence and lack of independence, which produced poor, sub-par information. Adopting laissez-faire principles, the Joint Stock Companies Act 1856 replaced the 1844 Act. The new legislation was better framed but provided for optional auditor clauses that could be included in the Articles of Association of a company as a means of self-regulation.[19]

Even after numerous global reforms, the provisions pertaining to statutory auditors were not forceful enough to bid adieu to massive corporate scams. Financial scams in major banks like Overend, Gurney and Company in 1866 and the City of Glasgow Bank in 1878 persisted with the help of falsified balance sheets and the kind. In one of the landmark cases of *In re Kingston Cotton Mill,* decided in 1896, an auditor's common law duties were specified quite extensively with the hope of curbing such financial menaces[20]. But the other side of the coin was that the verdict also limited the auditor's liability to only reasonable care and caution;illustrated by the example of an auditor being "a watchdog but not a bloodhound."[21]

In regards to India, the first consolidated Companies Act (CA) of independent India was passed in 1956 based off the 1943 English Companies Act. The act was introduced with a stricter approach towards the liabilities of auditors and specified that any clause in the Articles of Association of a company relieving them of such liability shall be void.[22]

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[16] Dorota Dobija, *The Early Evolution of Corporate Auditing: The English East India Company (1600-1640),* SSRN (Jul. 16, 2011), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=1886945.
[17] UK Competition and Markets Authority, *Statutory Audit Markets Study,* GOV.UK (Aug. 11, 2023 9:29 PM), https://www.gov.uk/cma-cases/statutory-audit-market-study.
[18] *Id.*
[19] Bishop C. Hunt, *The Joint-Stock Company in England, 1830-1844*, 43 JOURNAL OF POLITICAL ECONOMY 331, (1935).
[20] In Re Kingston Cotton Mill Company, (No. 2) [1896] 2 Ch. 279.
[21] *Id.*
[22] Companies Act, § 201, No. 1, Acts of Parliament, 1956 (India).

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B. The Need for Reform- Global Scams and Scandals

Over time the auditing standards and regulations changed to a great extent to bring about "good auditing." However, with several limitations relating to auditors' liabilities, duties and independence, such good auditing was still a far-fetched dream by the 1990s. The end of the 20th century and the beginning of the 21st century were marked with mammoth financial scandals that shook the commercial world and had far-reaching consequences. The UK scams of JP Morgan Securities and Equitable Life, the Italian Parmalat scam, the Comroad scam in Germany, the Enron and WorldCom scams of the USA and the Indian Enron case of Satyam are just a few of the prominent examples of corporate scams led by auditing failures and lack of disclosures. These scams and the financial global crisis of 2008-09 put up a great question mark on the auditing standards and unequivocally demanded changes around global jurisdictions to avoid these repeated instances. It caused a long-due realisation that whatever auditing practices, regulations and standards we had developed over the last many decades, had not been as fruitful as we had aspired them to be.

Following the Enron crisis, one of the most prominent legislations that were introduced was the United States Sarbanes-Oxley Act of 2002 (SOX). The implementation of the Sarbanes-Oxley Act (SOX) resulted in a substantial augmentation of regulatory measures pertaining to public firms and their auditors[23]. Several significant aspects of the Sarbanes-Oxley Act (SOX) encompass:

- The enhanced autonomy of auditors from their clientele.
- The need for enhanced auditor monitoring.
- The need for enhanced auditor reporting standards.
- The implementation of more stringent sanctions for instances of auditor misconduct.

The Sarbanes-Oxley Act (SOX) has been attributed to enhancing the standard of auditing not only in the United States, but rather globally as it set the path for major changes in the regulations for auditing standards and auditor independence in global jurisdictions, including India.

C. Naresh Chandra Committee, 2002

[23] JAYATI, *supra* note 1, at 364.

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Meanwhile in India, the Naresh Chandra Committee (NCC), an advisory board, was established by the Ministry of Finance and Corporate Affairs with the sole aim of realising the corporate governance ideals in the auditing realm. Triggered by the global and national financial frauds and the depreciating auditor-client relationship, the NCC was entrusted with the task of analysing the current scenario and suggesting thorough amendments in the laws governing auditor's duties, auditor-client relationships, and the independence of auditors. The committee submitted its report in 2002 with several sweeping recommendations for auditors, a few of which are listed below[24]:

- Listed disqualifications of auditors in order to prohibit the audit firm, their partners, or their direct relatives to have any personal, commercial, or undue influence relationship with the client. This was a great move to establish the long-sought auditor independence in India.
- Listed Non-audit services that the statutory auditors must abstain from providing, further bolstering the independence of the auditors from the internal operations of a company. This list included services like internal audit, bookkeeping, valuation, etc.
- Mandatory Auditor rotation. Moreover, at least 50% of the engagement team of an audit firm for a particular audit shall be rotated every five years.
- Mandatory submission of a certificate of independence by the auditors and auditing firms to the audit committee and the Board of Directors of the company.
- Quality Review Board (QRB)- The report also suggested setting up three independent QRBs to oversee the quality of audit, for ICAI (The Institute of Chartered Accountants of India), ICSI (Institute of Company Secretaries of India) and ICWAI (now ICAI, Institute of Cost Accountants of India).

Apparently, the narrow theme of all these recommendations is to establish the corporate governance idealsof independence and fairness in the statutory auditors' regime. As a result, almost all these recommendations were successfully enforced through the Companies Act, 2013 which brought the Indian auditing standards at par with the global level of best practices to a great extent.

D. CONTEMPORARY SCENARIO- REGULATORS AND REGULATIONS

[24]JAYATI, *supra* note 14.

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INTERNATIONAL REGIME

The oversight of the worldwide framework for external auditors is conducted by many organisations, such as the International Accounting Standards Board (IASB), the International Organisation of Securities Commissions (IOSCO), and the Financial Action Task Force (FATF). The IASB is responsible for establishing auditing standards that are used in more than 120 countries worldwide. Conversely, the IOSCO is tasked with developing standards specifically for the auditing of listed businesses. The Financial Action Task Force (FATF) establishes regulatory frameworks aimed at addressing the issue of money laundering, exerting influence on auditors standards worldwide.[25]

NATIONAL REGIME- INDIA

The regulatory framework for statutory auditors in India is now established by the Companies Act 2013 (CA 2013) and Clause 49 of Listing Agreementsby the Securities and Exchange Board of India (SEBI), 2004. The Companies Act of 2013 included many novel measures aimed at enhancing the standard of auditing and implemented all the major recommendations of the NCC (auditor rotation, prohibition of non-audit services, etc.), thereby greatly raising the bar for statutory auditing standards in India. One of the notable distinctions between the Companies Act of 2013 and that of 1956 is the heightened level of autonomy shown by auditors concerning their customers. The Companies Act of 2013 further strengthened the criteria for auditor supervision- the National Financial Reporting Authority (NFRA) in India now serves the purpose of overseeing the auditing profession and ensuring the regulation of auditing quality in addition to the existing regulators, SEBI, and Ministry of Corporate Affairs (MCA).Clause 49, established by SEBI in 2004, further outlines supplementary obligations for auditors of publicly traded businesses. The purpose of these standards is to guarantee the independence and proficiency of auditors working with publicly traded firms, as well as to assure the provision of auditing services of exceptional quality.

As illustrated, the regulatory environment for auditors in India has been greatly enhanced by the implementation of the Companies Act 2013 coupled with regulations like the SEBI (Listing Obligations and Disclosure Requirements) (Amendment) Regulations, 2017, hence fostering heightened trust and faith among the general public towards the auditing profession.

[25] ANDREA,*supra* note 3, at 311.

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IV. Stricter Regimes- Raising the Bar for Statutory Auditors

It remains a true fact that a governance system can never be ideal- it can only strive towards betterment to be as close to ideal as it can. As discussed before, the current worldwide regimes that govern auditing resulted as damage-control mechanisms in the wake of corporate regulatory loopholes, triggering scams such as those of Enron and Satyam. With the consequent losses and market disruption that followed, one would only hope that regulatory bodies take cognizance of such potential loopholes through their own analysis and foresight rather than waiting for a corporate blunder. This persistence to develop legal frameworks and better overall corporate environments require constant scrutiny of contemporary corporate scenario- resulting in measures and policies to 'raise the bar' for statutory auditors and their practices.

A. Recent Global Measures

The recent decade saw several changes in auditing policies all over the globe. For instance, the 2014 European Union audit legislation (audit reform package consisting of a directive and a regulation) is a crucial reform that has greatly influenced the process of conducting statutory audits for publicly listed companies. The legislation was implemented across the EU's 28 Member States as of June 17, 2016. It was later extended to include the three European Economic Area (EEA) countries. The changes encompass major updates to the roles and responsibilities of audit committees, the implementation of mandatory rotation of audit firms, additional limitations on auditors providing non-audit services to their auditees, and improvements to the regulatory and surveillance frameworks[26]. Moreover, Turkey has also introduced the Presidential Decision no. 6434 on "Determination of Companies subject to Independent Auditing" to provide thresholds (in terms of assets, net annual sales and number of employees) for various categories of publicly-traded companies, beyond which they would be mandatorily audited by an independent auditor[27]. As is, there already exists a

[26] Willem Pieter De Groen Et. Al, *Study on the Audit Directive,* CEPS (Nov. 01, 2022), https://www.ceps.eu/ceps-publications/study-on-the-audit-directive-directive-2006-43-ec-as-amended-by-directive-2014-56-eu-and-the-audit-regulation-regulation-eu-537-2014/.

[27]Gorkem Bilgin & Latif Aktas, *Recent Changes in Relation to Determination of Companies Subject to Independent Auditing,* Turkish Law Blog (Aug 11, 2023 3:46 PM), https://turkishlawblog.com/insights/detail/recent-changes-in-relation-to-determination-of-companies-subject-to-independent-auditing.

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whole classification of companies that are required to employ independent auditors regardless of the thresholds.

B. INDIA'S ATTEMPTS FOR ENHANCING AUDITING GOVERNANCE

Even examining the recent developments in a single jurisdiction, such as India, paints a decent picture of all the efforts being put forth by regulatory bodies in building stricter auditing regimes and creating safer investor environments. The most recent example of this is the Companies (Auditor Report) Order, 2020 (CARO 2020)- a significant step taken by the Ministry of Corporate Affairs, Government of India in collaboration with the NFRA. With this move, the government aims to regain the trust of different stakeholders in the financial statements of Indian companies, especially after the recent failure of IL&FS[28]. The notified changes are applicable to auditor reports issued in the financial year 2019-20 and onwards. Some of the changes introduced by CARO 2020 can be summarised below:

- Expansion in reporting a disclosure requirement: Auditor's Report added 5 new clauses and hence now covers 21 items, up from 16 in CARO 2016. The extent and manner of certain disclosures are also modified to be more expansive.
- Disclosure of income not recorded in books of accounts (clause viii): Companies must report undisclosed income from tax proceedings for better income assessment.
- Quality of internal audit assessed (Clause xiv): a statutory auditor shall assess and report on the adequacy of internal audit, keeping in view the size and complexity of businesses.
- Explicit reporting of cash losses (Clause xvii): Compared to just revenue losses, auditors are mandated to include cash losses from the current as well as the preceding financial year.
- Expert opinions on financial position (Clause xix): Auditors shall give opinions on the likelihood of companies fulfilling their short-term liability and report any threats of companies becoming non-performing assets.
- Enhancing CSR compliance (Clause xx): Mandated disclosures on unspent CSR funds.

[28] ET Online, *IL&FS: The Crisis that has India in Panic Mode,* THE ECONOMIC TIMES (Oct 03, 2018, 11:37 AM), https://economictimes.indiatimes.com/industry/banking/finance/banking/everything-about-the-ilfs-crisis-that-has-india-in-panic-mode/articleshow/66026024.cms?from=mdr.

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The MCA also notified the Companies (Audit and Auditors) Amendment Rules, 2021 ("Audit Amendment Rules") on March 24th, 2021introducing a new provision in line with the growing digital development: mandating the use of software that leaves an audit trail. Primarily, Rule 11 of the Audit Rules was revised to add components to be included in the Auditor's Report. Rule 11(g) states that the auditor's report must contain a statement regarding whether the company, starting from April 1, 2022, employs accounting software that includes an audit trail feature for bookkeeping purposes. It should also mention if this feature has been consistently used for "all recorded transactions throughout the year". Furthermore, the report should confirm that the audit trail has not been altered and has been maintained according to the mandatory requirements for the retention of records[29].

Furthermore, the recent judgement by the Apex Court in the case of *Union of India and Another v. Deloitte Haskins and Sells LLP & Another*concerning the constitutionality of removal of auditor under section 140(5) of the Companies Act, 2013 in light of auditor resignations further prove as evidence for stricter standards of statutory auditors. This case arose in September 2018, when IL&FS Group Companies defaulted on about INR 91,000 crore in debt. It jeopardized Indian financial markets and caused a stock market selloff. Due to immediate risks and a drop in investor confidence, the Department of Economic Affairs, Ministry of Finance submitted an Office Memorandum to the MCA seeking it to act under Section 140(5) of the Companies Act, 2013. The Supreme Court in this case affirmed the constitutionality of Section 140(5) of the Act and also bolstered the provisos of the section, including that of debarment of an auditor or the firm for five years if it is concluded that said auditor has behaved dishonestly or helped or worked together with the company, its officers or directors to commit fraud, whether directly or indirectly. The judgement essentially clarified that an auditor's resignation would not automatically terminate any proceedings initiated on the auditor under Section 140(5)- making sure that resignation does not become a loophole to be abused by auditing firms for weaselling out of liability in cases of questionable honest conduct[30].

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[29]Ruchika Chitravanshi, *Companies must have audit trail of transactions from next financial year,* BUSINESS STANDARD (Mar 15, 2023, 8:02 PM), https://www.business-standard.com/article/companies/cos-must-have-audit-trail-of-transactions-from-next-fy-123031501027_1.html.

[30] Union of India and Another v. Deloitte Haskins and Sells LLP & Another, 2023 SCC OnLine SC 557.

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The above-illustrated provisions and constant developments in the legal scenario pertaining to auditors signify the efforts of governments not only in India but all over the world to strive towards better financial accountability of companies and hence greater investor security.

C. How to Raise the Bar

While the changes introduced in the EU and Turkey tackle more basic issues pertaining to auditor independence and financial accountability of corporations, the changes introduced via the CARO 2020 work towards increasing the responsibilities of the statutory auditor already employed by companies. The amendments reflect broader auditor roles and hence create a demand for a broader skillset to be employed by them. In this way, the amendment caters to the popularized perception of the general public that the onus of identifying and uncovering frauds in companies that the public so 'cautiously' invests in, lies on the auditors. This narrative, to some extent, holds truth. However, by giving into this narrative, we mistake the role of a statutory auditor as that of a 'detective' or an 'investigator', as compared to that of a 'gatekeeper' or a 'watchdog'. It thus becomes imperative that we evaluate the direction that auditing policies are taking for ensuring financial accountability. We must understand how to properly raise the bar for statutory auditors to not only cater to stakeholders of corporations, but also consider the plight of those in the auditing profession themselves. The next chapter thus focuses on the possible implications of auditing reforms, the stringent policies and regimes that follow- both negative and positive, and how these changes may further shape auditing practices.

V. ImplicationsAnd Challenges

A. Practical Implications

As established in the case of Re Kingston Cotton mills, the notion that auditors are "watchdogs not bloodhounds" is lost in the contemporary world of ever-increasing duties of the auditors. Granted that many of the reforms introduced are necessary for fool-proof mechanisms to deal with potential cases of scams and failures that are not seen before; however, flipping the narrative on the head and approaching the issue from the auditors' side, the expanding lists of mandates, compliances and undue liabilities only serve as a growing headache to the profession.

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The major issue with the current regime of such development is that there are no policies in the pipeline to act as a balancing measure. There is a very apparent need for balancing the duties of the statutory auditors for financial accountability and the harsh liabilities being imposed on them for anything that might come under the purview of the expansive 'due diligence' standards that these auditors are supposed to meet.

A very good example might be that as of now, the MCA has notified 39 Standards of Indian Auditing under Section 133 of the Companies Act while the ICAI has notified 38 such standards. This is the increasing number of accounting standards that the statutory auditor is supposed to adhere to while making a single company's report. Further, the recent developments discussed above will surely have one implication in the public interest-extensive additional fronts on which inspection, report and disclosures would be sought from the Statutory Auditors.

But the other, and visibly more prominent implication is-increasing liabilities and risks for auditors. With the increased risks associated with the auditing profession, there has been introduction of penalties for their 'gross negligence.' There is also greater scrutiny on the national level by the NFRA, which is now vested with powers as wide as debarring the auditors or audit firms from taking up any auditing service for up to a decade, for any sort of misconduct. A recent example is the debarment of Deloitte in the IL&FS Financial Services Ltd. case[31]. Entering a cost-benefit analysis, it becomes apparent that the implication of these heightened standards is more risk and liabilities and harsher punishments for a stagnant remuneration.

The consequences have even extended to the level where an exemplary penalty of suspension of audit practices for three years have been granted as in the recent case of *ICAI v. Mukesh Gang*. The High Court of Hyderabad held the auditors to be grossly negligent and stated that, "if such grave professional misconduct, which affects the confidence of the public, is not dealt with sternly, it would encourage others to indulge in similar acts, and completely erode public faith in the impartiality and integrity of the ICAI members."[32] These recent

[31] KR Srivats, *IL&FS case: Deloitte partner Daruvala debarred from audit work for five years,* THE HINDU BUSINESSLINE (Jul 24, 2020, 03:50 PM), https://www.thehindubusinessline.com/money-and-banking/ilfs-case-deloitte-partner-daruvala-debarred-from-audit-work-for-five-years/article32182609.ece.

[32] ICAI v. Mukesh Gang, 2016 (6) ALT 606.

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developments seem to be doing away with the well-stated judgement of Re Kingston Cotton Mills.

The current regime has also resulted into numerous auditors resigning to avoid the risks that are now associated with the profession and new CAs being hesitant in entering the profession altogether. In 2019, the Big Four firm, Pricewaterhouse Coopers (PwC), resigned from being the statutory auditor for Reliance Capital Limited (RCL) and Reliance Home Finance Limited (RHFL) after only completing 2 out of the 5 years for which it had been appointed. PwC cited the reason of non-cooperation and adverse work environment with no substantive answers by the companies to their queries as their reason for resignation[33].

Another similar and more recent example is of Deloitte which resigned from being the Statutory Auditor for the firm, Adani Ports and Special Economic Zone (APSEZ) in August 2023. Although ASPEZ and Deloitte are citing different reasons for the resignation, the resignation has come quite shortly after Deloitte displayed certain concerns over some transactions of the firm as flagged by the US based firm, Hindenburg Research. This is not the first instance where Deloitte has resigned as Statutory Auditor. It had previously resigned from auditing of Manpasand Beverages Limited (MBL) back in 2018 citing similar reasons of non-cooperation from the company's side in sharing data with the auditors[34].

Taking note of the trend of resignations, SEBI issued a circular in 2019 to address the issue. Clause 6B of the circular tried to deal with the problem of non-cooperation by making it mandatory for the auditors to move to the audit committee for resolution and reiterated that the entities must make all necessary disclosures to the statutory auditors. However, the major focus of the circular was on tightening the grip on these resignations by envisaging that the firms must complete the audit report for a quarter or whole of the financial year, based on the number of days after the end of the quarter after which he is resigning[35].

[33] The Hindu Bureau, *PwC resigns as statutory auditor of RCap, Reliance Home Finance,* THE HINDU BUSINESSLINE (Jun 12, 2019, 10:12 PM), https://www.thehindubusinessline.com/companies/pwc-resigns-as-statutory-auditor-of-reliance-capital-reliance-home-finance/article27838562.ece.

[34] The Hindu Bureau, *Deloitte resigns as Statutory Auditor of Adani firm weeks after it flagged concerns over report by Hindenburg Research,* THE HINDU (Aug, 13, 2023 09:14 PM), https://www.thehindu.com/business/Industry/deloitte-resigns-as-statutory-auditor-of-adani-firm-weeks-after-it-flagged-concerns-over-report-by-hindenburg-research/article67191094.ece.

[35] Resignation of Statutory Auditors from Listed Entities and their Material Subsidiaries, Clause 6B, No. CIR/CFD/CMD 1/114/2019, Circular of Securities Exchange Board of India, 2019 (India).

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Such stringent regulations are likely to make it even more insecure for Statutory Auditors to undertake the auditing of potentially high-risk clients. There is no doubt that the statutory auditors are bound with the duty of exercising their diligence in a manner that meets the expectations of the public which relies on their reports and statements before investing their money. The auditors must take a call if faced with a dilemma while auditing a company's records and that decision should take heed of the public interest. But at the same time, there is an immediate need for putting a check on the liabilities and risks being imposed on the auditors in the current regime.

B. Challenges

The implications discussed above paint a picture of distress in the auditing community and markets that are a direct result of increased standards, compliances and hence liability for auditors. Consequently, we shall also discuss the challenges that these reforms and stricter regimes pose for the auditing profession and statutory auditing practices.

- Today's auditors are required to aggressively question management from the standpoint of a user and use professional scepticism. This inclination is a result of prevailing corporate culture within the auditing industry, fuelled by regulatory measures. With the previously illustrated tendencies of corporation to be non-cooperative, the in-depth scrutiny-based model is rendered useless, only becoming a burden on auditors and auditing firms who bear the liability that might arise due to non-compliance.
- Critics advocate for the enhancement of auditing practises, often suggesting the inclusion of forecasting or early warning mechanisms. However, practical constraints impose limitations on the feasibility of such improvements. Enhancements may be made to reporting and transparency, however, it is important to note that audits primarily serve as a limited assessment tool focused on financial statements, offering limited predictive capabilities over a short-term period.
- Limited research has been conducted to investigate the impact of the audit process on governance and management control, as well as the dynamics of the interactions between internal and external auditors, audit committees, and finance directors. There needs to be proper research conducted to deduce the effectiveness of reformative measures at regular intervals, instead of having just one-sided regulation.

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- Enhancing the standards for statutory auditors and implementing more rigorous rules is expected to result in an escalation in auditing expenses. This is due to the need for auditors to allocate more resources towards training, technology, and other essential assets in order to adhere to the newly imposed regulations. It might also potentially lead to a decrease in competitiveness within the auditing sector. This is since the new standards can only be met by auditors who possess the highest level of qualifications and expertise. This scenario has the potential to result in increased costs for auditing services and reduced options for firms. The reduced options further would affect the chances of finding independent auditors.
- Implementing stricter regulations and imposing higher standards for statutory auditors is anticipated to result in a rise in bureaucratic processes. This is due to the envisioned increase in laws and compliance standards that auditors will be obligated to adhere to. This could potentially pose challenges to auditors in carrying out their duties with optimal efficiency and effectiveness.

The careful consideration of the difficulties associated with elevating the standards for statutory auditors and implementing more rigorous regulations must be balanced against the possible advantages. If executed with caution, the implementation of higher standards for statutory auditors has the potential to enhance the overall quality of auditing practises and serve as a deterrent against instances of financial fraud. Nevertheless, it is crucial to acknowledge the prevalent obstacles and take measures to minimise their impact. Despite their indispensable value in Corporate Governance, statutory auditors cannot be made judges from gatekeepers. Even though changing times demand that some surface level investigatory practices be attributed to them, they should not be held liable to uncover complex scams that can hardly be deduced with financial statements alone. Delving into the challenges, it seems that regulation of professional ethos is not feasible via legislation, as even applying all these stringent standards would not ensure a fool-proof mechanism. Resultantly, we are employing new mechanisms that are nowhere close to being foolproof but are increasingly creating hurdles within the auditing profession. Rather, it is more viable to promote ethical dialogue and discussion with both- the companies and the auditors, in order to redirect our reliance to formulate standards imposing parallel responsibilities on both the stakeholders and not just the statutory auditor.

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VI. Conclusion and the Way Forward

By now it has been strongly established that the independence of auditors and audit committees has extreme significance in good corporate governance of corporate entities. The present state of auditor independence in India, particularly regarding the provision of non-audit services and the existence of conflicts of interest has been largely dealt with by the Companies Act of 2013. Moreover, the changes included as per the recommendations by the NCC have effectively addressed several vulnerabilities, helping our system align closely with established international standards and norms.

However, India, along with the world, is still striving for more nuanced auditor regulations in order to promote the much sought after investor security. Auditors have been made to don the outfits of detectives and save the investors by weeding out probabilities of corporate scams. More regulations, higher standards, innumerable compliances, and greater liabilities follow. The much-celebrated stricter regimes pose various challenges to the profession of auditors themselves. The idea behind determining the nexus between corporate governance and statutory auditors would not be fulfilled if the emerging regimes are not in line with sustainable development of the profession. There is a visible need for balancing the scales and making our auditing mechanism robust while ensuring and enhancing the auditors' sustainability.

Advancing forward, we need to take certain measures to achieve this idea of sustainable auditing. First, the regulators should abstain from using the statutory auditors as indirect mechanisms and for funnelling the need for corporate compliances through them to the companies. An example to explain this can be the regulators expecting the statutory auditors to report substantial cash losses as a fraud control practice to compel the companies to employ budget control mechanisms. Such indirect regulation imposes unnecessary liabilities on the auditors and contributes to the enumerated challenges. The regulators should rather make a bid to scrape off such responsibilities that are not essentials of the auditing process and undertake these tasks for themselves or their agencies.

Secondly, the issues faced by statutory auditors from the company's side, such as non-cooperation and incomplete disclosures need to be paid as much attention as we pay to instances of failure of due diligence by the auditors. There is a need for more proactivity among statutory auditors in their communication with regulators and stakeholders. The

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current regulations by SEBI[36] state that such instances are to be reported by the auditors to the audit committee but why stop at that. Such issues of non-compliance should also be communicated to the Registrar of Companies (RoC) and SEBI so that they can take necessary action and reduce these hassles for the auditors

Thirdly, research needs to be done for creating capacity for mid-tier firms to enter the market for auditing of large and quoted companies. It is generally seen that the auditing of all such companies is majorly done by the Big Four auditing firms and this is leading to a lack of competition in this market. The main fear of these mid-tier firms is of high litigation risks because of the higher susceptibility of major financial scams. This scenario demands urgent redressal and that can be done mainly by two ways- Doing away with entry barriers for the mid-tier firms into this market and balancing the liability-responsibility factor.

Lastly, as discussed, one of the primary obstacles encountered by statutory auditors pertains to the escalating intricacy of financial reporting. The use of intricate financial instruments and structures by businesses has posed challenges for auditors in evaluating the potential risks associated with financial fraud. In order to counter this problem, it is essential to allocate resources towards both training initiatives and technological investments for statutory auditors. This will assist audit firms in fulfilling the growing demands set out by regulatory bodies and stakeholders effectively.

To sum it up, the significance of addressing the persistent challenges is obvious and is the need of the hour. We need to diverge from the draconian principle of development and enhancement that sees more stringent substantive laws as positive development. It is very simple, you first increase the ability and safeguards for the watchdog, and only then expect them to fulfil their responsibilities with optimal efficacy and effectiveness. We need to take note of the corporate governance ideals while raising the bar for statutory auditors. Our idea of good auditing should be- high-quality auditing services while safeguarding the public and auditors' interest, despite the growing complexities they encounter. And the only possible way to achieve this is to first take steps towards balancing the scales as we move forward and have a vision of sustainable auditing development.

[36] *Id.*

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