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AUDIT QUALITY AND BOARD INDEPENDENCE

—Dr. Rajesh Chakrabarti

Abstract Corporate governance is increasingly becoming an important regulatory field all over the world. India has largely followed the path laid down by the corporate governance developments in the West. There have been several regulatory reforms and recommendations from various committees in this regard. Two of the recent regulatory developments in India have been the Kotak Committee Report, and the ban on Price water house Coopers for its involvement in the Satyam Scandal. Keeping these developments as a backdrop, the article seeks to analyse the issues related to the two important pillars of corporate governance: independent directors and auditors. Further, the article sheds light on the manner in which the relationship shared by these two pillars impacts the corporate sector.

The objective of this article is to reflect on the existing condition of corporate governance in India and critically analyse the responses to it using the recommendations made in the Kotak Committee report. Along with this, the article also proposes some suggestions for resolving the current problems. The article is divided into two broad sections. First, it discusses the practical realities of having informed and independent boards. Secondly, it analyses the impact of the quality of auditing on the...
boards. The article concludes with establishing the need to recognize the dependence of the quality of the board on the functioning of auditors.

I. INTRODUCTION

They say it takes a village to raise a child. The same is true, arguably even more critically, for raising and maintaining a well governed corporate sector. Two recent, independent regulatory developments in this space in India, both emanating from the Securities and Exchange Board of India (‘SEBI’), when seen together, underline the importance of the ‘interaction factor’ between two critical sets of stakeholders in this space, generally considered in isolation – the board of directors and the auditors.

The first is SEBI’s recent Kotak Committee report on corporate governance. It has been variably described as a “major milestone”\(^1\) to “arranging deck chairs on the Titanic”\(^2\). Although the report has explicitly stressed “evolution, not revolution” to characterize its approach to the quantum and speed of the change it seeks, parts of the establishment are clearly uncomfortable with its recommendations. The Ministry of Corporate Affairs (‘MCA’) — represented in the Kotak Committee — has objected to parts of it, and Union Minister Piyush Goyal, while acknowledging some of its merits, has called it completely “off the mark”. SEBI itself has skipped discussing it in its December meeting and is likely to take it up in its post-Budget meeting. All this creates an interesting setting for discussing at least three related but distinct questions — the novelty and criticality of the Kotak Committee’s recommendations themselves; the importance of the various dimensions of corporate governance covered by the Kotak Committee; the politically acceptable pace and quantum of reforms.

The other development is the two-year ban on Pricewaterhouse Coopers (‘PwC’) on auditing Indian firms imposed again by the SEBI, as a penal measure for the nine-year-old Satyam scandal. While the legal battle over this SEBI Order is likely to continue for months if not years, and it is a far narrower, sharper development than the Kotak Committee recommendations, there are interesting connects between the two developments that have occurred close to each other in terms of timing, more by accident than by design.

Two important sets of recommendations that the Kotak Committee made relate to two distinct pillars of corporate governance — the board of directors,

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particularly the institution of independent directors, on the one hand and the auditors on the other. The ban, obviously, relates exclusively to the latter. The individual importance of both these pillars is widely recognized. What is perhaps less widely understood is the dependence between the two. Usually thought of as separate entities, board quality and independence is inherently linked to the quality of auditing and financial reporting. That is the aspect that this article seeks to underline.

Corporate governance reforms in India have, by now, accumulated over two decades of history, going back to the Confederation of Indian Industries’ (‘CII’) Bajaj Committee in 1996. While each step in this fairly long journey has had its own signature characteristics, by and large the flow has mirrored world movement in thought and policy and its milestone reports — the Cadbury Committee recommendations of Europe and the rather reactionary Sarbanes-Oxley (‘SOX’) reforms of the United States (‘US’) in the wake of the Enron Worldcom meltdowns. The institution of independent directors has been uniformly stressed in both the Western setting as well as in India over this period. The Kotak Committee continues this tradition. What change this has accomplished on the ground, however, remains somewhat less clear.

Two factors further complicate matters for Indian reformers beyond what their Anglo-Saxon counterparts have to deal with — the controlling minority holding of promoter and ‘family’; and the related question of business groups. In the US context, the basic corporate governance conflict is vertical — ensuring that management works for shareholders — while in India the horizontal challenge — that the controlling block does not manage to deny the other shareholders their dues — is equally, if not more, important.

The attempt in this article is to use the setting provided by the Kotak Committee Report and the PwC ban to connect these two critical elements of corporate governance in India. It is not attempted to be a critique of the Kotak Report and its recommendations in the sense that it does not necessarily judge all or even most of the recommendations, but rather tries to locate a few selected recommendations in the context of the evolution of corporate governance thought in India in recent years and flags a few concerns in those areas.

II. INDEPENDENT, COMMITTED, INFORMED BOARDS – A REALISTIC OBJECTIVE?

Strengthening corporate boards and making them more independent have been the bedrock of corporate governance reforms. This objective is sought to be achieved through the device of independent directors. In this respect, as one looks at the recent history of corporate governance reforms in India, one is reminded of a famous quote of Indian economic policy — "Co-operatives have
failed in India; co-operations must succeed”. Independent directors have evoked similar unshakeable faith and steadfastness in the face of evidence among Indian reformers and each committee has sought to broaden and strengthen the role of independent directors. The Kotak Committee is no exception. The recommendations here continue to strengthen independent directors addressing several issues that are known to have affected Indian companies.

Most changes suggested by the Kotak Committee appear to add ‘more of the same’ in the hope that a higher dose of a failed medicine might just work. The logic appears to be that if mandating four meetings in a year does not seem to be accomplishing what is needed, surely five can only improve matters. There is nothing that is obviously right or wrong in the matter. It is unrealistic to expect academic research to point out the optimal frequency of board meetings and it is easy to see the logic that more of a good thing cannot hurt, even if it does not predictably help.

Two suggestions here make for some particularly interesting thinking. The first is the mandatory separation of the chairman and Chief Executive Officer (‘CEO’) with the chairman being necessarily independent and the second is the minimum compensation of independent directors (at very reasonable levels). The minimum board size of six is another interesting recommendation.

The question of chairman-CEO duality has long obsessed researchers and policy makers alike both in the West as well as in India for very valid reasons. However, it needs to be looked at with some realism as well. The influence of first generation promoters in India, not to speak of business family patriarchs or scions, was underlined recently in the entire Infosys spat. Clearly, there is more complication in boardroom politics in India than is reflected in management textbooks. It is probably not unfair to say that since the SEBI Clause 49 mandated independent director proportions, Indian promoters have by and large gamed the system with independent directors who are happy boarders rendered harmless through denial of information or lacking in intent and enthusiasm to interfere in the matters of corporate governance or monitoring.

It is not hard to see why this is the case. People who can understand the workings of a mid-to-large corporation without devoting at least a fortnight to a month’s attention in a year studying the company, are hard to come by in any country, most certainly in India. Such people bring true credibility to boards but also generally have immense value of their time. Now the ‘independence’ of the independent director gets compromised if he is compensated too significantly. Then how does a promoter have any hope of getting a really good independent director? Generally, board seats work out in a manner of a loosely reciprocal relationship amidst a network, with non-monetary payoffs ensuring that the time and effort spent by independent directors bears them some fruit too. Trust matters significantly, with the independent directors depending on the promoters and providing advice rather than monitoring. It is telling that a survey of independent
directors in India found that almost without exception, Indian board members see themselves as strategic advisors rather than watchdogs on promoters.\(^3\)

SEBI and corporate governance reformers over the last quarter century, however, have a different role in mind for them and refuse to give up when faced with evidence to the contrary. The Kotak Committee seeks to cover the minimum payment floor to motivate independent directors and tries to ensure through multiple recommendations that they are also well informed and powerful. This is, without a doubt, a noble objective. However, it is still unclear whether a five lakh floor does much to a person fit to sit on a top hundred board in India.

The point here is actually a broader one: how much human conduct can actually be mandated by rules and how much ought to be left to discretion? Can regulation really replace the role of culture and tradition? The Kotak Committee spells out in greater detail than any other committee before it what information needs to be shared amongst who and how much of that needs to be revealed to the shareholders.

Disclosure has transcended from being a tool to almost an objective in the corporate governance in recent years. As they say, sunlight is the best disinfectant. Trouble is, not all human activities can be done out in the open, particularly the ones involving relationships. When a regulatory system forces that, it risks having not the most transparent governance mechanism it hoped for but rather a staged sham of a box-ticking exercise masquerading as the decision-making mechanism while the real action moves away completely.

Many blame the SOX for moving companies away from the US or even pushing them into becoming private. Regulatory arbitrage is increasingly a possibility in a globalized world and there are costs of the Indian markets becoming overly restrictive and interfering. Regulators are far less sovereign in today’s world than we believe them to be, even if we disregard the balancing of political forces that govern rule-making.

Once we take that aspect into consideration, the concerns of Minister Goyal and other critics begin to make sense. There is, indeed, a point after which regulatory interference can be counter-productive, thereby affecting the increasingly vague ‘ease of doing business’ measure.

III. QUALITY OF AUDITING AND ITS IMPACT ON BOARDS

Apart from the board, the other stakeholders in the corporate governance environment involve the gatekeepers of information — auditors, rating agencies, etc. — and that has been the Achilles’ heel of the Indian corporate governance system. It is also an area that falls in more the contentious area of regulatory shared space — between SEBI and MCA at a very obvious level, but also of self-regulating bodies, like the Institute of Chartered Accountants of India ('ICAI') that have a critical role to play in ensuring the quality of the corporate governance inputs they provide. Several other committees in the past have commented on this. The Rajan Committee of the Planning Commission in 2008 (that had several members of this committee, including its chairman, as members) had, for instance suggested that SEBI insist on second independent audits of audited financial reports of a sub-set of listed firms. The recommendations in this area have therefore, expectedly created discomfort in some sectors. The ICAI, understandably, smirks at the suggestion of anyone else taking a hard look at auditors and views it as serious turf invasion.

The criticality of reforms in this area, however, can hardly be overemphasized. Reliable and trustworthy financial statements lay at the core of all business operations and governance and need no discussion. The point here is that, apart from being central to governance in itself, reliable and trustworthy audit is critical in ensuring board independence as well. The following figure (Fig. 1) underlines the connection.

(Figure 1)

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Figure 1 points to the increased board exits that happened in the immediate aftermath of the Satyam scandal almost a decade ago. The incident cast its long shadow over the corporate governance scenario in India. That the fourth largest Information Technology (‘IT’) firm of the country, with a stellar board comprising a former Cabinet Secretary, the inventor of the Pentium chip, and a Harvard Professor of Corporate Governance, could commit the largest and longest-running accounting fraud in Indian corporate history, shook the confidence of independent board members across the sector leading to these resignations.

What is important here is to understand the supply-side story of the independent directors. While committee after committee rightly advocates greater role and power of independent directors, strengthening the demand side of independent directors, relatively less thought is given to understanding the risks and benefits that independent directors face while joining boards. That is where quality of auditing plays a critical role.

First, the benefits. Independent directors gain prestige and contacts from serving on boards, and yet, in order to maintain their independence, cannot be paid beyond notional amounts – an aspect that is rightly addressed in the Kotak Committee, though with how much effectiveness remains to be seen. One can argue that board memberships can be monetized in other settings, as consulting fees or enhanced honoraria, but by and large they are not directly financially rewarding. The problem that creates is the failure to attract talent to the board or to motivate them to devote serious time to board matters.

Next, the risks. Till the Companies Act, 2013 (‘the 2013 Act’), came about, the risks associated with serving on Indian boards were substantial even for independent directors. Neither was the concept formally defined in law, nor were the responsibilities formally distinguished from that of their other ‘non-independent’ colleagues. As a result, situations arose wherein an independent director had to leave country for extended period to evade arrest in case the company was detected of committing fraud months after he had left the board. Basically, every board member was liable to be prosecuted in case the company committed an illegal act. Directors’ and Officers’ Insurance were not operational either. The 2013 Act, apart from formally defining the role, changed it to the following: “An independent director/ A non-executive director shall only be liable under this Act if the action/ omission is: with his knowledge; attributable through Board processes; where the Board has acted with his consent or connivance; where h/she has not acted with due diligence.” This provided significant risk reduction to accepting board positions for potential independent directors.

While the risk of prosecution is now considerably reduced, nevertheless, there is substantial reputation risk associated with board positions. Hence, board member candidates are well advised to think through the implications of accepting board positions which continue to be serious. The issue frequently boils down to the level of trust the potential independent director has on the controlling shareholders or promoters. More often than not, independent directors are at a substantial information disadvantage relative to the executive directors and the promoters about major business decisions — owing to either the delay in information sharing by management or to paucity of time available to absorb it at the director’s end — and have little choice beyond ‘going along’.

The least they can expect is that the audited financial statements provided to them are truthful and reliable. This is particularly true of the independent directors who lead or participate in board audit committees. An audit committee chairman’s responsibility far exceeds his real powers and quality individuals would be ill advised to accept such positions of responsibility without adequate protection.

It is precisely here that one pillar of corporate governance — board quality — critically depends upon the other — auditor quality. Over the years, the auditing profession in India has come under suspicion time and again and some even hold it at least partially responsible for the huge Non-Performing Assets (‘NPA’) problem plaguing the banking sector. Being paid by the client whom one audits is a relationship inherently prone to chances of abuse. While Chartered Accountancy remains a self-regulated profession, the investing public may be better served if listed companies have the assurance of an additional regulatory audit, a provision the Rajan Committee had argued for just a few months before the Satyam collapse.

IV. CONCLUSION

Auditors do have a lot riding on their shoulders. In the US, the audit major Arthur Anderson fell apart in the wake of its involvement in the Enron scandal, for good reason. At the end of the day, among all the pillars of corporate governance — the board, the auditor, the rating agencies, even the media — it is the auditor that has the closest view of corporate action in all its minutiae. All others take its output as their fundamental input and add value to it. Unless the quality of auditing is fixed, therefore, almost nothing in the rest of the corporate governance edifice can function well.

The corporate business system ultimately acts on faith. The faith that the small investor places on the system that would protect her investment in companies whose fortunes will be in the hands of people she is unlikely to ever meet in flesh and blood. Neither the chartered accountants, nor the ICAI with its extreme
reluctance in acting against its members in recent years, appear to have inspired that faith. The recent public rebuke from none other than the Prime Minister seems to underline that position.

The real crux of the Kotak Committee Report therefore lies well hidden in its seventh chapter (Accounting and Audit Related Issues) where matters of disclosure and auditor are discussed as opposed to the first few chapters listing several reforms to make for stronger boards. Whether it has gone enough in that area should be the real measure of its contribution to corporate governance in India for that is a far greater "binding constraint" than board independence per se. It would be a folly to expect effective and independent boards till the truth about companies in India can be kept hidden from the eyes of all but the promoters.