Current affairs noticeboard

Reforms to audit independence

Table 3

Committee Recommendations	**Included in relevant section of *The Companies (Amendment) Bill 2003***	**Concept paper (2004)(CP) and Concept Rules (CR)**
Some non-audit services to be prohibited (Recommendation 2.8)	Section 107	Section 59 (6). List of non-audit services not to be provided are included in clause 59(6) of Concept Rules
Auditor's to submit an annual certification of independence (Recommendation 2.8)	Not included	Not included
An audit firm should not earn more than 25 per cent of its revenues from a single corporate client. (Recommendation 2.1).	Section 106	Not included
Two years to elapse before a partner or member of the audit team can join a client or a key officer of the company joining the audit team (Recommendation 2.1).	Section 106 prohibits a person who has been in the employment of a company from being appointed or proposed to be appointed as the auditor of that company. Section 119 (e)	Not included

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	prevents an auditor of the company for the last three preceding years to be classified as an independent director	
Partners and at least 50 per cent of the audit team of a client should be rotated once every five years (Recommendation 2.2)	Not included	Not included

Discussion of major reforms relating to auditing independence

Similar to Australia and many other countries, regulation introduced in relation to auditing concentrated upon auditor independence. The Minister for Company Affairs stated the 'government is committed to independence of auditors' (Mishra, 2004, p.1). We shall now discuss the specific reforms suggested by the Naresh Chandra committee to audit independence.

In relation to the thorny question of auditors providing non-audit services, India has followed the US regulation in this area by drafting a list of non-audit services that auditors should not provide. Section 107 of the CAB lists these services and they include accounting and bookkeeping services, internal audit, actuarial services, financial systems and implementation, broker, investor advisor or investment banking services, outsourced financial services, management functions, valuation services and fairness opinion and any other services that may be prescribed. Section 59 (6) of the Concept Paper merely states that the non-audit services to be prohibited to be provided by auditors shall be prescribed. In commenting upon the list of services that shall not be provided by auditors in India, Sarathy, 2003, notes that services are prohibited so as to 'counter … management rewarding of an accommodating auditor discreetly through high value fees for other services disproportionately in relation to the real value of such services' (p.87). The list of services not to be provided is included in the Concept Rules shows a marked decline in the services not to be provided. The services not to be provided include internal auditing, maintenance of books of accounts and providing liaison services to other companies, financial institutions and government (Clause 59 (6)).

One of the provisions dealing with audit independence introduced in Australia is an annual declaration of the auditor's independence. The Naresh Chandra

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Committee recommended that annually the auditor should provide to the Audit Committee or Board of Directors a certificate of their independence (para. 15 of the Executive Summary). The ICAI were opposed to this recommendation arguing that it 'would result in more paperwork' (Srivats, 2003a, p.1). This recommendation was not included in the Companies (Amendment) Bill, 2003 or the Concept Paper.

An issue that the Naresh Chandra Committee considered was amount of fees that can be earned from one client and recommended that an auditor should not earn more than 25 per cent of its fees from a single client (Recommendation 2.1). The Naresh Chandra Committee Report describes situations where this occurs as being one where the auditor is unduly dependent on one client. An alternative title is fee dependence. As previously noted, the development of audit firms in India to compete with the multinational audit firms is seen as a problem in India and for this reason the requirement was not to apply to smaller Indian audit firms in the first five years of their operation (Recommendation 2.1). These provisions were included in Section 106 of the Companies (Amendment) Bill. This provision was not included in the Concept Paper.

Another issue that received much publicity in Australia is an audit partner or audit staff being appointed as a director or employee of the company. On this issue, the Naresh Chandra Committee recommended a cooling-off period of two years before such employment could occur (Recommendation 2.1). Note that cooling-off period also applies to a key officer of a client company who joins the audit firm. *The Companies (Amendment) Bill, (2003)* included a provision that prevents an auditor of the company for the last three preceding years being classified as an independent director. Neither provision was included in the Concept Paper.

Gridiharan (2004) writing in the ICAI's journal, *The Chartered Accountant*, notes that the provisions relating undue dependence and employment and cooling-off periods are part of the Naresh Chandra Committee's recommendations that should be subject to discussion and debate as to whether they could be included in the final amendments to the Companies Act that will be submitted in May 2005 (p.266). Table 3 shows these matters were not included in the Concept Paper and Concept Rules.

Auditor rotation has been a controversial issue in India. As long ago as in 1972, auditor rotation was being proposed as an amendment to the Companies Act (Shah, 2002, p.528). The Comptroller and Auditor General of India require auditor firm rotation for public sector undertakings and the Reserve Bank of India requires auditor firm rotation for banks (Srivats, 2003b, pp.1-2). The Naresh Chandra Committee considered the issue of auditor rotation and recommended that audit partner and 50 per cent of the engagement team be rotated (Recommendation 2.4). The committee's recommendation was based upon the fact that rotation of audit partner and

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staff was in line with international practice and 'no conclusive proof of the gains (of audit firm rotation) while there is sufficient evidence of the risks' (para.4 of the Executive Summary).

However, in July 2003 the Council of the ICAI gave an in-principle approval for the adoption of audit firm rotation (Srivats, 2003b, p.1). It seems one motivation for the adoption of audit firm rotation is that the policy of auditor firm rotation would be a 'ray of hope' for a number of small-sized audit firms in the country with some 'small firms … (alleging) that audit partner rotation would only benefit the "big firms" as they continue to hold on to their clients' (Srivats, 2003b, p1). A referendum was to be conducted among the members of the ICAI on this issue (p.1).

However, in July 2004 the ICAI rethought this issue and decided to refer the issue to an internal committee entitled *Committee on Ethical Standards and Unjust Removal* (Srivats, 2004a, p.1). A referendum to the members of the ICAI was still planned. The ICAI would also seek the referendum members' opinions of adopting the joint auditor system for listed companies (Srivats, 2004, p.1). This requires every listed company to appoint two independent audit firms who would 'take turns auditing the different functional areas of a company' (p.2). It is argued that this proposal would improve audit quality as each firm checks the other (p.2).

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