Financial Statements: The Fundamental Pillars of the Commercial World

Redefining the role of Independent Directors and Auditors

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'Forewarned is forearmed'— an expression often referred to by courts in relation to a company's duty of disclosure, underscores the regulatory objectives of transparency and fair play. This postulate attempts significant enhancement in the nature and rigor of disclosures in relation to a company's financial statement. Transparency and fairness in disclosures with respect to a company's financial position forms the foundation of good governance, and has garnered significant interest among regulators, investors and companies alike.

Over the years, regulators worldwide have revised the scope and rigor of disclosures of financial information, in tune with the evolving complexities of the market and the need to empower investors with information they need in order to prudently invest and define their risks in capital markets The objective is to reduce the asymmetry of information between the company, its management, large investors and those at the retail end of the capital markets.

As held by the Supreme Court of India, in a case involving large-scale manipulation of financial figures, financial disclosures are crucial to the accurate pricing of a company's securities and is key to upholding integrity of capital markets. Integrity here implies the absence of abuse, which in the ambit of financial reporting would mean an honest account of the financial statements, one that is not motivated by management discretion.

Market integrity being the objective and investors' confidence being its true test, the law sets to achieve two objectives— first being, transparency in disclosures and, secondly, ensuring that the information disclosed is adequate for investors in pursuit of their investment decisions.

The efficacy of financial disclosures holds key to upholding the integrity of the financial markets. Towards this goal, companies need to accomplish that the information provided is relevant, adequate and credible so to ensure that the information provides a 'true and fair view' of its state of affairs. The Companies Act 2013, which has its genesis in the backdrop of the global financial crisis and financial fraud like Satyam, has significantly enhanced the rigour of the financial statements, particularly in terms of the enhanced disclosure requirements, which a company needs to make.

Financial Reporting and an enhanced focus on Independence

It is the management which is responsible to prepare the financial statements of a company, in accordance with the established accounting principles. They follow fundamental assumptions, which are consistent, prudent, comparable and fair. The process of generation of financial statements, its inherent controls over reporting and robustness of judgement forms the bulwark of corporate governance. The independent vanguards like the auditors and Independent Directors play a pivotal role in deepening governance in a company, which feeds into the entire economy in due course.

It is the responsibility of directors as a whole to prepare the annual records and reports and those accounts should reflect 'a true and fair view'. The two pillars on which market integrity rests, being disclosure and transparency, it is for both auditors and the directors to comment on the whether the financial statements fulfils these twin tests. Hence, the role of the Audit Committee— as the overall oversight mechanism into financial reporting of a company, relies on the effectiveness of the auditor. The responsibility is embodied in the assertions made in public disclosures by both these constituents in the form of their reports— the directors' responsibility statement and the auditor's report.

Audit Committee is an important governance mechanism designed to ensure the adequacy and credibility of financial statements. The Audit Committee plays a vital role in ensuring the independence of the audit process.

In theory, Audit Committees should perform two roles—first, shield the auditor from the management pressures ensuring that they obtain all relevant information and are in a position to verify all the actions of the management and are independent in their duties and beliefs, and secondly, ensure that the controls and environment are conducive to making evidence based conclusions, which get reflected in form of financial statements and information.

Audit Committee— which under the requirements of the new Companies Act, 2013, is composed of a majority of independent directors, is required to act independently and not be subject to management pressures. The onus on Independent Directors is greater than other directors on the board or the audit committee. The additional responsibility bestows due to the nature of their duties, in pursuance of which they are required to 'satisfy themselves on the integrity of financial information and that financial controls and the systems of risk management are robust and defensible'. (Schedule IV, Companies Act 2013).

Role of the Audit Committee in the Financial Reporting Process

The corporate governance regulations under the Companies Act, 2013, and the revised Clause 49 of the Listing Agreement has significantly enhanced the role of audit committee's in the financial reporting process. The regulatory requirements entail that the financial statements reported reflect a true and fair view of the state of affairs of a company.

The Companies Act, 2013, has considerably enhanced the mandate of Audit Committees to cover diverse matters — financial risk oversight, evaluation of performance and effectiveness of audit process, oversight of internal financial controls, RPTs, creating a fair vigil mechanism, and monitoring end-use of funds raised through public offers etc.

While auditors opine on the truth and fairness of financial statements, the ultimate responsibility of those statements lies with the management — owners who prepare statements. The design and operating effectiveness of internal financial controls are also the responsibility of the management. The Audit Committee plays an oversight function, by examining those financial statements and evaluating internal financial control systems and risk management procedures.

Independent Directors have an onerous duty to perform as Audit Committee members which involves significant use of skill, expertise, and judgment. In fact, the Code for Independent Directors clearly states that they shall satisfy themselves on the integrity of financial information, and that financial controls and risk management systems are robust and defensible.

As a subject-matter expert, the onus is on an Independent Director is to demonstrate their rigour, expertise and independence in dealing with matters that come up for consideration of the Audit Committee. This is embodied in the Act and SEBI regulations. While all members in an Audit Committees, are collectively accountable for their functions, Independent Directors in such committees especially the financial expert have an additional duty to fulfil, consistent to the expertise they hold.

The expertise of an independent director is a double-edged sword. While expertise of an Independent Director may on one hand initiate higher accountability standards as against other members of the Audit Committee, as has been applied by US Courts in case of breach of duties, the same expertise if acted upon with diligence can help Independent Directors ward off potential liability actions if they have acted fairly irrespective of the erring majority view. The directors need to demonstrate the exercise of their judgement and scepticism beyond all reasonable doubt, when called upon to demonstrate their basis of conclusions.

Assessing Internal Financial Control Framework

The significant change which has come with the passage of the Companies Act, 2013, has come in relation to a company's assessment of the internal financial control framework. Clause 49 of the Listing Agreement requires Audit Committees to independently assess the company's internal financial control framework which, inter-alia, requires the company to have in place policies and procedures with respect to,

- prevention and detection of frauds and errors;
- accuracy and completeness of accounting records;
- timely preparation of reliable financial information

The Audit Committee needs to independently review the existence, adequacy and operational effectiveness of the policies and procedures on these aspects. In terms of the adequacy of internal financial control, the board and the audit committee is required to provide an assurance in relation to the company's financial statements, i.e. internal controls over financial reporting (ICFR). The auditors, on their part, are required to report whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

For the Audit Committee to demonstrate that it has taken necessary steps to evaluate the IFC systems, it may call for the comments of the internal auditors and the statutory auditors about the company's internal control systems, scope of audits, etc. as this would give them additional insights on the assessment of such controls. The audit committee, if required, also seek external help or expert advice and guidance for the evaluation of the internal financial controls.

To meet the enhanced duties, Audit Committee is required to ensure they act in greater coordination with the internal and the external auditors. The need to exercise oversight on the company's financial reporting process forms a significant part of the responsibilities of the Audit Committee. It requires meaningful review with special emphasis on major accounting entries and significant adjustments made in the accounts before they are put up for approval of the Board.

As the courts have held on numerous occasions dealing with instances of dereliction of duties by audit committee members, Audit Committee members are expected to and must demonstrate an application of mind in dealing with matters that comes before them, and not merely approve as they come.

Enhanced role of Auditors

Financial audits add credibility to the implied assertion by an organization's management that its financial statements fairly represent the organization's position and performance to the company's stakeholders. The objective of an audit of financial statements is to enable the auditor to express an opinion whether, apart from representing a true and fair view of the company's financial state of affairs; and assert that the financial statements are prepared in accordance with the applicable accounting standards.

Independence of the audit process is the touchstone on which its effectiveness is to be measured. The Code of Ethics issued by the ICAI (referred to in SA 200) describes independence as comprising both independence of mind and independence in appearance. While auditors need to be independent, the Audit Committee has a key role in ensuring that the audit process remains independent and unhindered.

The new regulatory framework has substantially enhanced the duties for external auditors' as the auditor's report, in addition to their general duties has to state any qualification, reservation or adverse remark relating to the maintenance of accounts. Further, the requirement to state whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls, makes the role of auditors, onerous.

Auditor's independence, which as past incidents of financial fraud highlights, has been compromised. Under the enhanced regulations, it is critical for auditors not just to be independent but also ensure that their actions demonstrate the independence they apply in the audit process.

Reporting of Fraud

The Companies Act, 2013, has widened the scope of fraud to enlist a range of actions or inactions, irrespective of whether they lead to any wrongful gain or loss which reflects that it is not just the illegality of the act but also the intent itself which constitutes guilt. Section 143(12) of the Companies Act 2013 requires an auditor to report on fraud if in the course of performance of his duties as an auditor, the auditor has reason to believe that an offence involving fraud is being or has been committed against the company by its officers or employees.

In accordance with Section 447 of the Companies Act, 2013, fraud includes 'acts with an intent to injure the interests of the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss.

Therefore, to fall within the meaning of fraud, the following should have happened—

- acts, omissions, concealment of fact or abuse of position;
- such acts, omissions, concealment of fact or abuse of position should have essence of mens rea in them;
- irrespective of the fact whether or not they resulted in 'wrongful gain' or 'wrongful loss'

Under the Companies Act 2013, deliberately making false statements or omission of material facts in financial statement is construed to be fraud as defined under section 447 of the Act. The onerous nature of the provisions comes in view of its applicability, which inter-alia, has enhanced the responsibilities of the auditors. In accordance with the provisions, an auditor guilty of fraud or abetment or collusion, both the partner and the firm shall be jointly and severally liable.

The challenges for auditor to fulfil the rigors of section 143(12) of the Companies Act, 2013, which deals with auditor's responsibility for consideration of fraud in an audit of financial statements, are apparent. As ICAI's Guidance Note on reporting on fraud states, an auditor may not be able to detect acts that have intent to injure the interests of the company or cause wrongful gain or wrongful loss, unless the financial effects of such acts are reflected in the books of account/financial statements of the company.

ICAI's guidance hence, states, that the auditor shall consider the requirements of the Standards on Auditing (SAs), insofar as it relates to the risk of fraud, including the definition of fraud as stated in auditing standard (SA) 240, in planning and performing his audit procedures in an audit of financial statements to address the risk of material misstatement due to fraud.

The enhanced liability for missing out reporting instances of fraud, it is necessary that they have access to all relevant details and do not face management challenges in the conduct of audit.

Conclusion

There is an enhanced focus on the role of Audit Committees and auditors, as tightening of regulations highlights. The enhanced requirements demand greater attention to the processes laid down by the company and use of independent judgement.

The expanded nature of duties for an Audit Committee requires its members to be vigilant in discharge of their duties. Independent Directors must reflect this concern through meticulous reading of documents, asking additional information wherever needed and utilising the services of experts like external counsels, forensic experts and valuer.

The knowledge of Independent Directors is not at test all by itself, as they have at their disposal a plethora of tools in the form of use of experts to secure that their view is the correct. Since the discharge of the Audit Committee functions requires adequate financial knowledge and expertise, a requirement which is more so in case of Independent Directors seated on such a committee, it is crucial for the members to demonstrate their independence in discharge of their duties.

To fulfil the regulatory expectations in relation to the financial statements, it is crucial that the Audit Committee, auditors and internal auditors work in greater coordination. The enhanced accountability may not cascade into liability breaches, so far the Audit Committee members are in a position to demonstrate fairness in their action through use of an independent judgement in discharge of their duties. The nature of duties for the auditors, demands significant attention to details while ensuring that the rules of the game are complied with alacrity.

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