

THE ROLE OF AUDITORS IN THE CONTEXT OF CORPORATE GOVERNANCE

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Abstract

Auditors examine company's accounts and report to the company on the accounts. Fundamentally, the concern is how auditors carry out these duties effectively. Legislations namely Companies Act 1965, Securities Industry Act 1983 which has been consolidated as Capital Market and Services Act 2007 have made major inroads to ensure that auditors carry out their duties and obligations effectively. Additionally, the Code of Corporate Governance was drawn in 2001 and amended in 2007, to further enhance the effectiveness of audit in the interests of stockholders and stakeholders. Nonetheless, it is pertinent to determine whether the Code of Corporate Governance is adequate and comprehensive in ensuring that auditors play effective role in auditing a company. This is particularly imperative in the light of recent scandals involving auditors in Malaysia and in other parts of the world. The study then proceeds to explore the appropriate litmus test in laying down sound principles governing the duties and obligations of auditors. This is crucial because there is increased reliance by the stockholders and stakeholders on auditors. Moreover, there is a growing concern for corporate governance domestically, regionally and globally. Thus, a comparative study is also carried out as to how the issue of corporate governance is addressed in other parts of the world. Finally, the study shows that the Malaysian Code of Corporate Governance governing the duties and obligations of the auditors has not produced the desired result pertaining to accountability.

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1. Introduction

This study examines the role of auditors under the Code of Corporate Governance. The study then reviews the financial scandals involving auditors which occurred within Malaysia and in other countries. In reviewing the scandals, this study will investigate the cause for such scandals. The study will show whether the auditors' duties and obligations as provided by the Code are comprehensive in addressing the scandals.

2. Auditors and Corporate Governance

Corporate governance is an internationally debated interdisciplinary concept with many characteristics (Nobel, 1998). However, the concern is whether in the context of corporate governance, auditors play an important role. This is vital since the duties and obligations of the auditors fall under the purview of Part III of the Malaysian Code of Corporate Governance which was originally drawn in 2000.

Auditors are given wide powers to enable them to detect wrongdoings by the management. They are expected to be independent of the company and report on the company objectively. In fact, auditors can only play their role effectively if they are independent (Peel & O'Donnell, 1995). The auditors are able to remove management's biasness as regards to the presentation of the company's financial information (Carmichael, 1977). They can report to what extent the company practices corporate governance. They are expected to play a significant role in maintaining good corporate governance (Ali, 1999). They must ensure that good corporate governance practices are adopted (Anandarajah, 2001). They must act as the guardian of the company's financial integrity.

This is because an effective and objective audit is an essential part of corporate governance (Low, 2002). This is to ensure that the legal position is in tandem with international standards in the realm of corporate governance. Thus, it was correctly stated in *Simonius Vischer & Co v Holt* (1979) that the duty is extended to checking the conduct of any servant or director of the company. Notably, corporate governance is a key factor for institutional investors in deciding whether to invest in any company (McKinsey & Co, 2002). Furthermore, corporate governance mechanisms have a positive effect on the issue of accountability (Dewing & O'Russell, 2004).

Nonetheless, all the scandals occurred although the Code was already in place. Furthermore, initiatives have been taken by drawing up the Code in ensuring that the Board of Directors is responsible and accountable. However, the same could not be said in relation to auditors per se *i.e.* there is no specific code governing auditors' role, duties and obligations.

Notably, in 2007 the Code has been revised. One of the purposes is to strengthen the role of external auditors and its relationship with the audit committee of a company (SC issues revised code of corporate governance, 2007).

In Part I of D III, the Code provide that the Board of Directors should establish formal and transparent arrangements for maintaining an appropriate relationship with the company's auditors. If auditors are allowed to offer non-audit services, it is questionable whether the relationship is still formal since the auditors have to be in the good books of the Board of Directors. Furthermore, the manner the Code is drafted shows that it is the duty of the Board of Directors to have a formal relationship. The Code should have been drafted in a manner which reads "The relationship between the Board of Directors and the auditors should be formal."

Furthermore, the Code reads that arrangements should be transparent. If that is the case, then it is the duty of the Board of Directors to disclose matters relating to non-audit services. Nonetheless, the issue is whether non-audit services fall within the purview of arrangements. Rightfully, it does. Ironically, the duty is on the Board of Directors to do so. The Code should have required the auditors to disclose at the time of appointment if there are any non-audit services rendered by them to the said company or any of its related corporations.

Much emphasis is placed on auditors in the context of corporate governance because in most cases, auditors will be the first person to spot corporate exploitation. This is due to the nature of auditing function and the purpose of auditing company accounts. It can also be a case of the only person who is aware of the exploitation besides the wrongdoers. Thus, in many cases the auditors choose to fail to detect the wrongdoing at the expense of their duties and obligations.

3. Lessons from Financial Scandals

There is a need to clarify the duties and obligations of auditors due to the recent spate of financial scandals (Tomasic, 1992). Financial scandals have always been one of the major reasons for change in the company law (Lee, 2002). Nevertheless, it should not be a case of learning the wrong lesson from those

financial scandals (Deakin & Konzelmann, 2004). The financial scandals prove to show that the auditors have fallen below the expected standards. If a company were to fail within certain months after being audited, the auditors are blamed for conducting an inferior audit (Dopuch, 1988). Thus, the most common question asked whenever there has been a financial scandal is, whether the auditors carried out their duties and obligations properly (Reilly, 2006). On the other hand, distinction should be made between audit failures and business failures. In the former case, the blame should be attached on the auditors. In the latter case, there are external factors attached. This is because not all business failures are due to audit failures.

Enron, the Texas-based energy trading company is the first scandal which shook up the auditing profession although there were many cases involving auditors since the 18th century. Enron has caused a crisis to the confidence in auditors (Worden, 2002) and the reliability of financial reporting (Holm & Laursen, 2007). The audit quality and the independence of the auditors were questionable (Davis, 2002). This is because the auditors, who were Arthur Andersen, were not only receiving fees for auditing but for non-audit services too *i.e.* for consultancy services. In 2001, Arthur Andersen earned US\$55 million for non-audit services (Brown, 2005). There were regular exchanges of employees within Enron from Arthur Andersen.

Under the Code of corporate Governance, although formal relationship between the Board of Directors and the auditor is essential, the Code does not deal with the issue concerning the offering of non-auditing services to the company. Nevertheless, what is obvious is that there will be conflict of interest and therefore the independence of the auditor will be affected.

However, under the Code, there is no duty reposed on the auditors to avoid conflict of interests. Thus, the fact that Arthur Andersen was offering non-audit services is not a breach of the Code in the first place.

A further issue is that although Arthur Andersen was making a report on the company's accounts, they did not report fraud to the stockholders and stakeholders. This is because the fraud was committed by the management. Kenneth Lay took home US\$152 million although the company was facing a loss. If the auditors were to report they probably will not be appointed in subsequent years or be engaged for non-audit services. They made sure that they were in the management's good books. They maintained confidentiality but for the wrong reasons.

The U.S. government assured the stockholders and the stakeholders that Enron was just a case of one bad apple. Nonetheless, in 2002, WorldCom which is one of the biggest telecommunications company in US collapsed. The company faced US\$28 billion in loans and yet Bernie Ebbers who ran the company was given a loan of US\$366 million (Banyard, 2002). The auditors were Arthur

Andersen. It was found that the auditors did not take proper steps in detecting accounting irregularities (Wong, 2004). Although it is the duty of the auditors to detect accounting irregularities, they failed to do so. Since they failed to do so rightfully they should be liable.

In Australia, the collapse of HIH Insurance Ltd was seen as the beginning of the reflection into auditors' role, duties and obligations. The auditors were Arthur Andersen. The auditors were providing audit and non-audit services. Furthermore, the auditors ignored a document dated July 1998 which showed that HIH had been substantially under-reserved for many years (Main, 2002). The company collapsed in March 2001, creating a loss of AUS\$5.3 billion (Mackerras, 2003).

Another scandal in Australia involved One-Tel which is a mobile telecommunications company. The company collapsed with AUS\$2.4 billion in debts and losses (Robbins, 2006). One of the main reasons for the collapse is that the independence of the auditors was questionable and further the auditors made erroneous judgments on the company's financial affairs (Houghton & Jubb, 2003).

In Malaysia, Transmile Group Bhd has sparked of concern regarding auditors' duties and obligations. The company is controlled by billionaire Robert Kuok. There were accounting irregularities and fraud discovered in the company (Transmile shares extend fall, SC vows swift action, 2007). The company has overstated its accounts to show it has made profits of RM75 million and RM158 million for the two consecutive years of 2005 and 2006 respectively. In actual fact the company was at a net loss of RM370 million and RM126 million respectively (Transmile rebounds strongly, 2007). The stock dropped to RM9.55, which is the lowest in two years (Transmile: A bumpy ride, 2007). The auditors Deloitte & Touche declined to approve the accounts when the company failed to furnish them proof to substantiate certain trade receivables. However, the loss was not detected by Deloitte & Touche. It was detected through a special audit by Moores Rowland (Transmile audit shows losses in 2005, 2006', 2007). The audit was then carried out on CEN Sdn Bhd which is an associate company.

Deloitte & Touche dismissed the claim that they failed to detect the accounting irregularities. Furthermore, it claimed that it is not practicable to expect audit to represent a 100 per cent check of a company's financial well-being (Deloitte defends role in transmile', 2007). As a result of the scandal, the company wishes to replace Deloitte & Touche with KPMG after many years (Transmile may pick KPMG to be auditor', 2007). It should be noted that KPMG is already an auditor for some of the companies owned by Robert Kuok namely Hong Kong listed Keck Seng Investments and Shangri-La Hotels (Malaysia) Bhd. KPMG is also offering due diligence and corporate tax advisory services to PPB Bhd a company owned by Robert Kuok. Thus, the issue is whether there is conflict of

interests and independence of auditors. However, until and unless the issue is addressed, auditors are free to offer non-audit services.

In Ocean Capital Bhd, a retailer company in the domestic market registered a RM3.85 million deficit in its shareholders funds for the first quarter financial results ended March 31 2003 (Ocean capital reclassified as PN4', 2003). The company has been facing a loss since 2000. Nonetheless, the loss was not brought to the attention of the shareholders by Deloitte & Touche who were the auditors.

In Megan Media Holdings Bhd, it was found that there was fraudulent trading (Megan media in more hot water', 2007). There has been a default of RM900 million of bank loan. It has incurred a net loss of RM1.27 billion in the financial year ended in April 2007 (Megan Media Posts RM1.27b Loss, 2007). However, the auditors failed to report the matter.

In matter involving Bumiputra Commerce-Holdings Bhd (BCHB), BCHB is planning to bring a legal action against Deloitte Kassim Chan over audit work on the then Southern Bank Bhd (SBB) (Audit on southern bank properly conducted: Deloitte', 2007). This is because there has been inappropriate accounting treatment on the 2005 accounts. This was found by Price-waterhouseCoopers (PWC). They were inappropriately valuing certain derivative financial instruments, not writing down in full the collateral value and wrongly writing back specific provisions made on certain foreclosed properties relating to non-performing loans aged seven years and above and non-expensing of certain costs incurred. Furthermore, the net assets were overstated by RM160 million. BCHB exercised a takeover of SBB. BCHB is not planning to bring an action against the Board of Directors as it could not find any evidence of fraud (BCHB mulls legal action over SBB audit, 2007).

As far as the banking sector is concerned, 70% of the fees that banks pay to their auditors are for non-audit services (A murky sort of pond life', 2007). The independence of the auditors is questionable because the decision to engage auditors for non-audit services rests with the Board of Directors. If the auditors detected that the Board of Directors has committed a wrongdoing and report the matter to the shareholders of the company, they may not be engaged for non-audit services.

One of the ways to counter financial scandals is to improve the quality of auditing services (Steps to improve accounting firms, 2007). Nonetheless, the current legal, regulatory and corporate governance framework is robust and sufficient to protect the market (Yusoff, 2007). This cannot be so. This is because the number of financial scandals involving auditors is increasing. Furthermore, whilst corporate governance may have improved but the auditors' duties and responsibilities are shrouded in mystery and mystique as ever (Leek, 1996). This can be seen not only in the international arena but also in the domestic front.

There is a *lacuna* in the current legal framework as the duties and obligations imposed on auditors are inadequate in countering financial scandals.

4. Modern Approach to Auditors' Duties and Obligations

The duties and obligations of auditors must be determined in reference to the purpose for which an audit serves in the Malaysian economy. The duties and obligations must be made more relevant, useful and reliable to existing individual shareholders, directors, audit committee, prospective shareholders, employees, creditors, guarantors, companies wishing to exercise takeovers, mergers and acquisitions, trustees, beneficiaries, regulatory bodies, government and members of the public. Furthermore, from an international perspective, the duties and obligations of auditors have been widened (Nobel, 2003).

Therefore, in conducting an audit, auditors are now obliged to take a much stricter approach to their clients (Bourne, 1995). There is an increasing support for the view that auditors should take on a more active role (Baxt, 1970). Thus, there is a clear need to depart from the metaphor that auditors are merely watchdogs, to formulate more exacting duties and obligations of the auditors.

Provisions have been enacted in 'the Companies Act' in relation to appointment, eligibility, qualification, disqualification and removal of auditors (Davies & Prentice, 2003). The intention is to ensure that auditors are able to conduct auditing in an impersonal, objective and professional manner. Furthermore, it is also to ensure that auditors are independent of the company. This is because independence is the virtue an auditor's honesty (Francis, 1990) Auditors being professionals just like other professionals must be independent of the client that is receiving the service (Green, 2006). The underlying reason for such emphasis and requirement is to ensure the auditors are not in a position of conflict of interests.

However, in some cases there is possible conflict of interests despite the measures taken by 'the Companies Act'. This is because in reality there is conflict of interests. This has been seen in cases where auditors provide non-auditing services to the company which they are auditing. This is because some auditing firms have branched to diversified services beyond auditing since non-audit services are lucrative. It has reached a point where auditing and non-auditing services has become indistinguishable (Jeppesen, 1998).

It was reported that in 2000, the 'Big Four' earn 50% of their income from management and consulting field which was only 13% in 1981 (Securities & Exchanges Commission, 2000). There is also evidence that revenue from other services has been increasing (Palmrose, 1986). In such a case, the auditors

have put themselves in a position where there is conflict of interests. The independence of the auditors has been compromised due to the close relationship between the company's management and the auditors. This is because the company's management has decided to engage the auditors for non-audit services. This close relationship has been termed as 'familiarity threat' (Hussey, 1999). Consequently the auditing standards have also been compromised. However, it was felt that in principle there is no conflict on interests (Brehm, 2004). But what is more important is the reality. Thus, independence of an auditor is integral to the auditor's duties and obligations.

Auditors can only obtain the contracts for non-auditing services if they maintain a good relationship with the management. Furthermore, auditors are dependent on their clients for livelihood. Thus, the auditors are under extreme pressure to ensure that they are retained. If they qualify the report or manage to detect the wrongdoings of the management, it is unlikely that they will be appointed by the management in the future. Thus, auditors may be lenient to their clients which give room to further conflict of interests. Auditors should be able to carry out their duties without fear or favour. This raises concern about ensuring objectivity and independence. Furthermore, it poses danger to the credibility of auditors.

Although the law attempts to ensure that auditors are not too closely connected with the company whose accounts they are auditing, but the distance could and should be further (Ussher, 1986). If auditors are allowed to provide non-audit services, the auditor will be closely connected. Moffit J in *Pacific Acceptance Corporation Ltd v Forsyth* (1970) found that this conflict is real, practical and apparent and that auditors must guard against this. The conflict worries stockholders and stakeholders.

Therefore, where there is such conflict of interests, disclosure must be made to stockholders and stakeholders. Alternatively, there should be prohibition with regards to providing of non-audit services to the company where they act as auditors. This is to ensure that the auditor is impersonal, objective, professional and independent. The Ethics Standards Board which is part of the UK accountancy regulator is of the opinion that auditors should not provide audit and non-audit services to the same client (Parker, 2002). Nonetheless, in Malaysia there is no such prohibition.

Rightfully, the Code should be amended to include a provision that an auditor should not be allowed to offer any form of non-audit services to the company, which may put the auditors in a position of conflict of interests.

A further problem with regards to the closeness between the management and the auditors is that in practice, it was found that the demarcation between the duties of the auditors and the financial reports released by the management is unclear. This is because there have been negotiations and compromises between the management and the auditors (Stephen & Watts, 1997). The

management of the company prefers to engage the auditors for non-audit services because of the comfortable personal relationship with the auditors (Joseph, Hermanson & McGrath, 1992). Therefore, the concern is where does the duty of the management end and when does the duty of the auditor begin.

A point to be noted is the length of the auditors' relationship with the company (O'Sullivan & Diacon, 1999). This is because this will reflect whether the auditors are truly independent and whether there can be possible conflict of interests. Thus, to ensure auditors are truly independent and are not in conflict of interests, auditors should be rotated every year. Thereafter there should be a gap of five years before the same auditors are engaged by the company. This is because independence of auditors cannot be expected out of a matter of professional ethics (Hollingsworth, White & Harden, 1998). The crux of the matter is that auditors are appointed as monitors and not a bonding mechanism for the management (Fan & Wong, 2005).

5. Conclusion

Company is the most popular form of business entity today as compared to sole traders and partnerships. Each decade passes with more and more companies being formed to do businesses. A company is able to raise capital for its operational needs. However, it is important that the capital raised by a company is used for lawful purposes. To ensure this, auditors are under a duty to audit the company. Nevertheless, if the duties and obligations of auditors are minimal, eventually, the use of a company will be misused. Simultaneously, businesses are also collapsing whereby it affects the rights and interests of the stockholders and stakeholders. Since such is the magnitude on the importance of auditors, equal importance should be placed on the duties and obligations of auditors. An audit provides a high level of assurance about an accountability matter which is expressed as reasonable assurance. Otherwise the information contained in the report would be lost and misleading. The duties and obligations of auditors must be expanded for the sake of capital market, stability of financial and economic sector and the rights and interests of stockholders and stakeholders. A higher audit quality will provide better information to them. There must be a modern approach to the auditors' duties and obligations in the context of corporate governance.

[3491 words]

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