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# Auditor and Audit Committee Independence in India

Jayati Sarkar and Subrata Sarkar

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**Jayati Sarkar and Subrata Sarkar**
**Indira Gandhi Institute of Development Research (IGIDR)**
**General Arun Kumar Vaidya Marg**
**Goregaon (E), Mumbai- 400065, INDIA**
**Email (corresponding author):** ssarkar@igidr.ac.in

**Abstract**

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Jayati Sarkar*
Subrata Sarkar
Indira Gandhi Institute of Development Research

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*Jayati Sarkar and Subrata Sarkar are faculty at Indira Gandhi Institute for Development Research, Goregaon(E), Bombay, telephone number +91-22-8400919. Email: jayati@igidr.ac.in, ssarkar@igidr.ac.in. This paper was produced as part of the *Financial sector regulatory reforms* project.

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# 1 Introduction

The Enron debacle in the US, which led to the Sarbanes-Oxley Act of 2002 ("SOX")[1] in the US, influenced far reaching changes in regulations governing auditor independence and audit committee across the world. In India, the economic reforms which began in 1991 have put great emphasis on the role of the external auditor and the audit committee. The "Clause 49" regulations[2] which were made part of the Listing Agreement by the Securities Exchange Board of India (SEBI) in 2001 required every listed company to have an audit committee and specified its composition, role, and power in detail. The Naresh Chandra Committee ("NCC")[3] that was constituted in August 2002 produced an exhaustive report on the auditor-company relationship and the functioning of the audit committee. Many of these recommendations have been incorporated in the Companies Bill, 2009[4] which is currently waiting for legislative approval.

Theory and the empirical literature overwhelmingly suggest that auditor and audit committee independence plays an important role in the governance of companies. The recommendations of the NCC have set standards which are line with international best practices. The Companies Bill, 2009 has incorporated many of these recommendations. For investors to have confidence in the independence of the auditor, the Companies Bill, 2009 needs to be enacted quickly into law. At the same time, there are many areas for improvement in the Companies Bill of 2009. The paper reviews the regulations and the suggested governance reforms in India with respect to auditor and audit committee independence.

On the issue of auditor independence, the paper discusses three key aspects which regulations try to address, namely (a) disqualification for audit assignments that arise due to potential conflicts of interest from employment, financial interest, and other relationships between the auditing firm and the audit client, (b) types of non-audit services rendered by the auditing firm, and (c) audit partner rotation.

On the issue of disqualification for audit assignments the NCC recommended that an audit firm will be disqualified from being appointed as the statutory

[1]Sarbanes-Oxley Act of 2002, http://www.law.uc.edu/ccl/soact/toc.htm

[2]SEBI, Clause 49 Regulations, Circular No. SEBI/CFD/DIL/CG/1/2004/12/10 October 29, 2004. http://www.sebi.gov.in

[3]Naresh Chandra Committee Report on Corporate Audit and Governance (2002)

[4]The Companies Bill, 2009, http://www.mca.gov.in/Ministry/actsbills/pdf/Companies_Bill_2009_24Aug2009.pdf

external auditor if the audit firm, its partners or members of the engagement team as well as their 'direct relatives' had any (i) financial interest in the audit client, (ii) received any loans and guarantees from the audit client (iii) had any business relationship with the audit client and (iv) had any personal relationships with the key officers of the audit client. In addition, the NCC also recommended (v) a cooling period of two years before any partner or member of the auditing firm can join the audit client, or any key officer of the audit client can join the auditing firm, and (vi) prohibition on undue dependence on an audit client in terms of audit fees.

The Companies Bill, 2009 incorporated the first four recommendations of the NCC report, but the recommendations regarding undue dependence and, more strikingly, the recommendation regarding the cooling period were not incorporated in the Companies Bill, 2009. The latter recommendation comes from the basic concern that a member of the audit engagement team who has only recently been a key officer of the audit client poses significant "self-review" threat as these persons will be less inclined to detect errors that they themselves may have committed in their capacity of a key officer of the audit client. Simultaneously, a key officer of the audit client who has only recently been a member of the auditing firm can significantly influence the auditors incentive, ability, and inclination to detect potential accounting and financial errors by the audit client.

With respect to prohibited non-audit services the NCC recommended nine types of services that an audit firm was prohibited from rendering to its audit client. The list of services mimic the list of services prohibited by the SEC except for legal services and expert services which are prohibited by the SEC but not recommended by the NCC. The Companies Bill, 2009 incorporated the first seven recommendations of the NCC[5] but did not include the recommendations relating to (i) any form of staff recruitment, and particularly hiring of senior management staff for the audit client and (ii) valuation services and fairness opinion in the list of prohibited services.

On the issue of compulsory audit partner rotation the NCC recommended that all partners and at least half of the audit engagement team (excluding article clerks) be rotated after five years. The recommendation also provided for a cooling period of five years before rotated members can join the audit engagement team for the particular audit client. The NCC recommendations regarding auditor rotation are very similar to those specified under SOX regulations, but these have not been adopted in the Companies Bill, 2009.

[5]The Companies Bill, 2009 broke up the investment adviser or investment banking services separately into investment adviser services and investment banking services.

Mandatory rotation exists for government firms but not for private listed companies.

The paper also looks at the size, composition, independence, and powers and functions of the audit committee, which plays a vital role ensuring the independence of the audit process. In doing so it makes a comparative assessment of such regulations in other countries.

While a significant number of proactive regulations have been enacted in India since the 1990s, there are two aspects which require further attention: the composition of the audit committee and its authority to implement its decisions. A review of the sequence of regulations shows that there has been a steady dilution of the independence requirement with respect to the audit committee. The original Clause 49 regulations required the audit committee to have a minimum size of three and to be constituted entirely of non-executive directors with majority of them being independent.[6]

The revised Clause 49[7] removed the non-executive director requirement and instead specified that the audit committee have a minimum of three members with two-thirds of them being independent. The Companies Bill, 2009 follows the revised Clause 49 regulations by not insisting that the audit committee comprise only of non executive directors but reverts to the majority rule rather than having a two-thirds rule.[8] Given the minimum size of three a reversion to the one-thirds rule as opposed to the majority rule does not impose any extra constraint. The NCC in its report, while applauding the existing Clause 49 regulations on the audit committee, pointed out that one area that needed improvement and tightening was the composition of the audit committee and recommended that if the audit committee is perceived to be independent, then it should consist only of independent directors. Unfortunately this has not been incorporated in the Companies Bill, 2009.

The weaker independence requirement regarding the composition of the audit committee has to be seen in context of the fact that the audit committees recommendations relating to hiring, oversight, compensation, and firing of the outside auditor are not binding on the Board, in contrast to the regulation in the US where under the SOX Act of 2002, the audit committee is "directly

[6]SEBI, Clause 49 Regulations, Circular No. SMDRP/POLICY/CIR-10/2000, dated February 21, 2000. http://www.sebi.gov.in

[7]SEBI, Clause 49 Regulations, Circular No. SEBI/CFD/DIL/CG/1/2004/12/10 October 29, 2004. http://www.sebi.gov.in

[8]Section 158 (2) of the Companies Bill, 2009 specifies that "The Audit Committee shall consist of a minimum of three directors with independent directors forming a majority and at least one director having knowledge of financial management, audit or accounts."

responsible for the appointment, compensation, retention and oversight" of the statutory auditor and each such statutory auditor "must report directly to the audit committee."

After the Companies Bill, 2009 is enacted as law, two areas of work pending with policy makers are: the issue of independence of the audit committee both in terms of its composition and the power of the Board to overrule its decisions, and the issue related to conflict-of-interest in auditor-company relationship and audit partner rotation. These issues have to be addressed in future regulation to make auditing and oversight standards in India comparable to those in the more mature economies. If it is operationally difficult to obtain amendments of law in the near future, then SEBI and the Stock Exchanges need to explore the possibility of incorporating these additional standards of independence in the Listing Agreement. Since the provisions of the Companies Bill, 2009 can be interpreted as only laying down minimum standards, nothing prevents stock exchanges from insisting on higher standards of independence from companies listed under their supervision.

This paper is structured, starting with a review of the regulations and governance reforms on auditor independence (Section 2) and audit committee independence (Section 3) of Indian firms, comparing them with the regulations existing in the US. This is followed by a discussion of the existing research on the effectiveness of audit committees and audit independence in corporate governance in Section 4. Section 5 present recent trends in audit committee and auditor characteristics for a sample of the large listed companies in the Indian corporate sector. The paper concludes by suggesting some governance reforms that may be considered to further strengthen auditor independence and the functioning of audit committees in India in Section 6.

# 2 Auditor independence

Auditors are the lead actors in the auditing process and provide independent oversight to the financial reporting by companies. Modern day corporations are huge and their operations are complex. While accounting standards and norms are specified by the regulators for proper disclosure. Yet preparation of proper financial reports requires an evaluation of the judgements and assumptions made by the management, along with their justification of the final choice among several alternative accounting principles. Consistency

of applications in preparing accounts and coverage of all relevant financial aspects are required.

Auditors scrutinize and verify the accounts, as well as certify that the financial statements are prepared in accordance to the prescribed principles and that the accounts are free from material misstatements. It is therefore expected for the law in all countries to have put enormous responsibility on the auditors to ensure that the accounts give a true and fair view of the operations of the company. In the US, the SOX Act has put great emphasis on auditor independence. Following the Act, the US Securities and Exchange Commission (SEC)[9] has made specific rules to put the provisions of the Act into operation. At home in India, a similar effort has been made by the NCC, which has given a series of recommendations that have been incorporated in the Companies Bill (2009) and are awaiting parliamentary approval.

The rules and regulations regarding auditors independence framed by regulators are predicated on some fundamental principles. The NCC lists two fundamental principles behind auditor's independence namely, (i) *independence of mind* - which permits arriving at an informed and reasoned opinion without being affected by factors that compromise integrity, professional scepticism and objectivity of judgement and (ii) *independence in appearance* - which requires avoiding facts, circumstances and instances where, an informed third party could reasonably conclude that integrity, objectivity and professionalism has, or may have, been compromised (NCC, 2004; pp 36). As the NCC rightly points out "for the public to have confidence in the quality of audit, it is essential that auditors should always be - and be seen to be - independent of the companies that they are auditing." Thus, when situations of potential conflicts arise, the law in general has taken a sceptical view and erred on the side of caution by putting the interest of the general public before the interest of the auditor.

Similar principles are enshrined in the Code of Ethics for Professional Accountants, prescribed by the International Federation of Accountants (IFAC) which identifies five types of potential threats to auditor's independence:

- *Self-interest threats*, which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client.
- *Self-review threats*, which occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement, or

[9]Sarbanes-Oxley Rule making and Reports, `http://www.sec.gov/spotlight/sarbanes-oxley.htm`

when a member of the audit team was previously a director or senior employee of the client.

- *Advocacy threats*, which occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised.
- *Familiarity threats* are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests.
- *Intimidation threats*, which occur when auditors are deterred from acting objectively with an adequate degree of professional scepticism because of threat of replacement.

Building on these five fundamental principles, both the NCC and the SOX Act have put in place a number of regulations/recommendations regarding the qualification of auditors for engaging in statutory audit, the type of non-audit services that they can render, the need for rotating members of the audit engagement team, and restrictions on the extent of non-audit fees that an auditing firm can get from an audit engagement. The single purpose of these efforts has been to ensure auditor's independence.

## 2.1 Key aspects of auditor independence

The three key aspects of auditor's independence which all regulations try to address are:

1. A potential conflicts of interest that arise from employment, financial interest, and other relationships between the auditing firm and the audit client,
2. Types of non-audit services rendered by the auditing firm, and
3. Audit partner rotation.

The NCC has deliberated extensively on these three aspects and come up with recommendations which are in line with the international best practices and which closely follow the provisions under the SOX Act.

### 2.1.1 Disqualification for audit assignments

Conflict of interest is one primary concern of the regulators for ensuring auditor's independence. The NCC recommended that an auditing firm will be disqualified from being appointed as the statutory external auditor if the audit firm, its partners or members of the engagement team as well as their 'direct relatives' had any (i) financial interest in the audit client, (ii) received any loans and guarantees from the audit client (iii) had any business relationship with the audit client and (iv) had any personal relationships with the key officers of the audit client, i.e. any whole time director, CEO, CFO, Company Secretary, senior management belonging to the top two managerial levels and the officer who is in default.

In addition, the NCC also recommended (v) to have a cooling period of two years before any partner or member of the auditing firm can join the audit client, or any key officer of the audit client can join the auditing firm, and (vi) prohibition on undue dependence where under which a audit firm was disqualified from auditing if the fees from any single audit client exceeded 25 percent of the total revenues of the audit firm. The recommendations were tight that in that it included all the affiliates and the subsidiaries of the both the audit client and the audit firm in the determination of independence. Section 124 of the Companies Bill (2009) incorporated the first four recommendations of the NCC report. The recommendations regarding undue dependence and, more strikingly, the recommendation regarding the cooling period were not incorporated in the Companies Bill (2009).

The recommendation regarding undue dependence had attracted some debate as this may affect the survival of the small firms. The NCC has been sympathetic to this argument and had specified that its recommendation with respect to undue dependence were not applicable to audit firms for the first five years from the date of commencement of their activities, and for firms whose total annual revenues were less than Rs.15 lakhs per year. The principle of "intimidation threat" which is likely to operate on the audit firm when it is reliant on a few clients for its survival may have prompted the committee to make this recommendation. Equally arguable, of course, is the reverse viewpoint that if regulatory action for wrong doing is credible, then the audit firm is likely to work even more diligently when it has only a few clients. Coupled with this, the audit committee which is envisaged to play a critical role in ensuring that the external auditor is protected from the pulls and pressures of the management may have prompted the Companies Bill (2009) to not include this recommendation for enactment. Similar regulation

on undue dependence, however, does not exist in the SOX Act.

The more striking omission from the Companies Bill (2009) is the NCC recommendation of providing a cooling off period before a member of the audit engagement team can join the audit client or a key officer of the audit client can join the audit firm. This recommendation comes from the basic concern that a member of the audit engagement team who has only recently been a key officer of the audit client poses significant "self-review" threat as these persons will be less inclined to detect errors that they themselves may have committed in their capacity of a key officer of the audit client. Simultaneously, a key officer of the audit client who has only recently been a member of the auditing firm can significantly influence the auditor's incentive, ability, and inclination to detect potential accounting and financial errors by the audit client. The recommendation views passage of time to be essential in reducing the possibility of influencing the policies of the accounting firm and the resultant perceived loss of independence.

The provision of the cooling period is one of the major concerns under the SOX Act. Section 206 of the SOX Act specifies that an accounting firm cannot perform an audit of a company "(i)f a chief executive officer, controller, chief financial officer, chief accounting officer, or any person serving in an equivalent position for the issuer, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that issuer during the 1-year period preceding the date of the initiation of the audit[10]". The SEC while framing its rule on "Conflicts of Interest Resulting from Employment Relationships" for implementing these provisions of the SOX Act expanded the coverage of the cooling off period from the four specified key officers named in the Act to any person in a "financial reporting oversight role." However, recognizing the over-reaching nature of the laws, it narrowed down the application of the cooling period to only the lead partner, concurring partner, and any other member of the audit engagement team body who provided ten or more hours of audit,review and attestation services (SEC Rule 208-2).

There are some notable differences between the SEC rule and the recommendations of the NCC.

1. Under the NCC recommendations, the cooling off period applies to not only the audit partners but to all members of the audit engagement team. In contrast the SEC rules are applicable to the lead partner, concurring partner, and to only those members rendering ten or more

[10] http://www.sec.gov/rules/final/33-8183.htm

hours of audit services, the assumption being that some minimum amount of participation is required for a member to have significant interaction with the management during the audit process.

2. Under the NCC recommendation, the cooling off period is applicable irrespective of the employment position which the former audit firm member takes up in the audit client and not restricted to positions with financial reporting and oversight role as it is under the SEC rules.

3. The NCC recommendations apply not only to members of the audit firm taking up positions in the audit client, but also to employees of the audit client taking up positions in the audit firm.

4. Finally, the cooling off period under the NCC is two years while it is one year under the SEC rule.

Perhaps the first two recommendations of the NCC are too broad in their applicability and can be narrowed down to some extent. The major criterion in determining the applicability of the law should be the ability and the incentive of the members of the audit firm and the audit client to influence the effectiveness of the audit process. Unlike the SEC, the NCC recommendations that require the cooling off period to also apply to employees of audit client while joining the audit firm is a well thought out move that recognize that reverse influence that former employees of the audit client can exercise when they are part of the audit engagement team. However, in this case too, the scope of the recommendation can be made narrow by making the law applicable only to key officers of the audit client joining key positions in the audit firm. Thus the ideal rule would be one which provides for a cooling period before the lead, concurring or any significant member of the audit engagement team takes up a financial reporting oversight role in the audit client or a person in a financial reporting oversight role in the audit client becomes a lead, concurring, or a significant member of the audit firm. The terms "significant audit member" could be defined based on the nature and duration of services by the audit member. The extent of the cooling period could be left to the decided based on norms and practice in other countries.

### 2.1.2 Prohibited non-audit services

Provision of non-audit services is another major concern for the regulator in ensuring auditor independence as rendering many of these services puts the independence of the auditor standard at significant risk. Auditing firms

have incentives to perform non-audit services to augment their income and because of the informational advantage that they gain during the auditing process about the financial status of the audit client. Accordingly, laws in various countries list a number of services that an auditing firm is prohibited from rendering to its audit clients. The prohibition of non-audit services comes from the two principles, namely, the self-review threat and advocacy threat outlined earlier. Similar principles are highlighted by the SEC when it mentions that "the Commission's principles of independence with respect to services provided by auditors are largely predicated on three basic principles, violations of which would impair the auditor's independence: (1) an auditor cannot function in the role of management, (2) an auditor cannot audit his or her own work, and (3) an auditor cannot serve in an advocacy role for his or her client."[11]

The NCC recommended nine types of services that an audit firm was prohibited from rendering to its audit client. The list of services mimic the list of services prohibited under the SEC except for legal services and expert services which are prohibited under the SEC but not recommended by the NCC (Box 1). The SEC puts forward purposeful arguments built on the principle of "Advocacy Threat" for including these two services in the prohibited list but the NCC does not cite any reasons for excluding them in its recommendations. Further under the SEC Rules (208-6) the lead, concurring and audit partner cannot receive compensation based on selling engagements other than audit, review and attestation services as rendering these services can hamper an accountant's objectivity and shift the focus from audit to non-audit works. Other members of the audit engagement team however can receive compensation for rendering non-audit services provided those are not in the prohibited list are approved by the audit committee. No such rule exits in the Companies Bill, 2009 nor is recommended by NCC.

Section 127 of the Companies Bill (2009) incorporated the first seven recommendations of the NCC[12] but did not include the recommendations relating to (i) any form of staff recruitment, and particularly hiring of senior management staff for the audit client and (ii) valuation services and fairness opinion in the list of prohibited service. Under the SEC both (i) appraisal or valuation services, fairness opinions, or contribution-in-kind reports as well as (ii) human resources services are strictly prohibited. As the SEC recognizes in its discussion of Rules, that when an auditor actively assists the management

[11] See Strengthening the Commission's Requirements Regarding Auditor Independence, Section II.B http://www.sec.gov/rules/final/33-8183.htm

[12] The Companies Bill (2009) broke up the investment adviser or investment banking services separately into investment adviser services and investment banking services.

to recruit, train and evaluate employees for the audit client, especially in senior management positions, the "accountant would be reluctant to suggest the possibility that those employees failed to perform their jobs appropriately, or at least reasonable investors might perceive the accountant to be reluctant, because doing so would require the accountant to acknowledge shortcomings in its human resource service.[13]" With respect to valuation services and fairness opinions the SOX Act recognizes that undertaking these services may put the accountant under the self-review threat of having to review his or her own work as these services often require the auditing firm to make key assumptions, projections, and valuations of a company's assets, cash flow and other relevant financial variables that can become the subject of audit later. Also while valuation services are fairness opinions that are offered mostly for judging the sufficiency of consideration in a financial transactions, thsese are likely to be based on an aggressive assessment of risk assessment as opposed to the conservative assessment that is expected of auditors when auditing the companies' accounts in public interest.

It is apparent that an expanded list of prohibited services is not in the interest of the auditing firms. Rendering valuations services, fairness opinion and human services can provide significant opportunities of augmenting the revenue of audit firms especially when the fees from audit services is low. Thus restricting these services can significantly hamper the survival of the audit firms, especially the smaller ones. Yet the survival of the auditing firms has to be balanced against the interest of the public at large to ensure that the integrity of the auditing process is not jeopardized. If survival is the reason for not enacting these two provisions into law then it puts the independence issue into serious question as audit firms are more likely to stand by their assessment as doing otherwise put them at risk of losing these non-audit services. On the other hand if these services account for insignificant proportion of revenue of the audit firms then there is a greater reason to include them in the prohibited list as doing so does not materially affect the auditing firm but increases the public's confidence in the audit process.

### 2.1.3 Compulsory audit partner rotation

Rotation of audit firms as a means of safeguarding auditor independence has been a subject of intense debate for many years. Proponents of

[13]See Strengthening the Commission's Requirements Regarding Auditor Independence, Section II.B `http://www.sec.gov/rules/final/33-8183.htm`

**Box 1: Comparing the prohibitions of the NCC and the US SEC**

Prohibited non-audit services under the NCC (Recommendation 2.2), juxtaposed against analogous prohibitions of the US SEC:

| NCC | SEC |
|---|---|
| • Accounting and bookkeeping services, related to the accounting records or financial statements of the audit client. | • Bookkeeping or other services related accounting records or financial statements of the audit client. |
| • Internal audit services. | • Internal audit outsourcing. |
| • Financial information systems design and implementation, including services related to IT systems for preparing financial or management accounts and information flows of a company. | • Financial information systems design and implementation. |
| • Actuarial services. | • Actuarial services. |
| • Broker, dealer, investment adviser or investment banking services. | • Broker-dealer, investment adviser or investment banking services. |
| • Outsourced financial services. | |
| • Management functions, including the provision of temporary staff to audit clients. | • Management functions. |
| • Any form of staff recruitment, and particularly hiring of senior management staff for the audit client | • Human resources. |
| • Valuation services and fairness opinion | • Appraisal or valuation services, fairness opinions, or contribution-in-kind reports. |
| | • Legal services |
| | • Expert services |

Of the NCC recommendations, the new proposed Companies Bill 2009 omits the last two.

compulsory audit firm rotation advance two arguments for mandatory audit firm rotation namely (i) decline in audit quality and competence and (ii) loss of independence due to long association (Joe Hoyle, 1978). With respect to the former, these proponents point to the laxity in standards and the decline in creativity that occurs when working for an audit client for long period and argue that mandatory auditor rotation is necessary for a fresh look. In addition, mandatory rotation is expected to lead to better audit quality

by increasing competition among audit firms, reducing the dependence on a single client and increasing audit effort as incumbent firms are likely to work harder when they are aware that their work will be shortly reviewed by another auditor. With respect to the latter, these proponents point to the significant familiarity threat that occurs with long association causing the auditor to develop friendly ties and to endorse the views of the management.

Opponents of mandatory auditor rotation point out that modern day corporations that have complex financial operations cutting across national borders demand auditors who are well versed in accounting standards and auditing rules specified by the laws and regulations of each country. Accordingly, opponents argue that mandatory audit firm rotation can pose even greater threat to audit quality by resulting in loss of continuity and reducing audit competence. In addition they point to the increase in training costs by audit firms which are eventually likely to be passed to the audit clients.

Those who do not support mandatory audit firm rotation do acknowledge the potential problems that can arise out of long term association of the auditor with the client. What they disagree with is whether rotating the audit firm is the *best way* to solve the problem given the potential cost that mandatory rotation involves. Instead they suggest that the improving the regulatory framework governing the appointment and functioning of the auditor, enhancing accounting and reporting standards, and making auditors responsible for their oversight role would be a safer and better way of ensuring audit independence.

Given the equally persuasive arguments of both sides, regulators in various countries have tried to strike a balance between the need for a fresh look with concerns about loss of continuity and decline in audit quality and competence, by requiring audit partner rotation instead of rotation of the audit firm itself. In India, the NCC recommended that all partners and at least half of the audit engagement team (excluding article clerks) to be rotated after five years. The recommendation also provided for a cooling period of five years before rotated members can join the audit engagement team for the particular audit client. In the US, the SEC rules (208-4) require the lead partner and the concurring partner to rotate after every five years and specify a five-year time out period before they can return to the audit engagement team. In addition, the rules also define "audit partners" as those who played a significant part in the auditing process and require them to rotate after seven years of engagement and subject to a two year time out period before joining the audit engagement team.

In the US, rotation rules were very lax, until the enactment of the SOX Act which made sweeping changes. In India, there are no formal rules regarding auditor or audit partner rotations and the recommendations of the NCC represent the first attempts to formalize the norms in this respect. In general, the NCC recommendations regarding auditor rotation are very similar to those specified under the SOX regulations, but these have not been adopted in the Companies Bill, 2009. Mandatory rotation exists for government firms but not for private listed companies. This omission leads urgent rethinking, especially in light of the Satyam failure[14] which brought into focus the importance of having vigilant auditors and audit committees in corporate governance.

## 2.2 Powers, responsibility and accountability of auditors

Given the enormous importance of auditors in ensuring the integrity of the financial reporting process, the law gives adequate powers to the auditors to help them discharge their functions effectively and the same time requires that auditors follow prescribed auditing standards and take responsibility of their actions. Section 126 of the Companies Bill, 2009 gives the auditors the right to access to all information relevant for the audit from any place in India.

In the case of a holding company, Section 126 gives the auditors the power to access the records of all its subsidiaries that it deems necessary for preparing consolidated accounts. The last provision is particularly important given the presence of business groups which have listed companies with multiple subsidiaries and for which proper consolidated accounts are required to judge the financial health of the companies.

The Bill also makes unilateral replacement of the auditor difficult by requiring a "Special Resolution" to be passed before an auditor can be removed from office before the expiry of its term. However, the NCC recommendations that a "Special Resolution" be passed in the case of a retiring auditor, who is otherwise qualified for re-appointment is replaced, has not been included in the Companies Bill (2009).

In terms of ensuring auditor responsibility, the Companies Bill (2009) requires the auditors to prepare and sign an Auditor's Report that has to read to the

[14]For a detailed examination of the case of Satyam, see (Chakrabarti and Sarkar, 2010; Chakrabarti *et al.*, 2010).

shareholders in the "Annual General Meeting" (AGM) with the report being available for inspection by any shareholder. The audit report must state whether the auditor obtained all information that were relevant to the audit, that all internal controls are in place and proper books of accounts have been kept and that the financial statements have prepared in accordance to the accounting and auditing standards specified by the National Advisory Committee on Accounting and Auditing Standards[15] and give a true and fair view of the state of affairs of the company at the end of the financial year. The Bill requires the auditors to point out qualified opinion, reservation or adverse remark relating to the maintenance of accounts and in case a qualified opinion is passed, the auditor's report has to state the reasons behind it. The NCC recommendation that the audit firm should send a copy of the qualified report to the Registrar of Companies (ROC), SEBI and the relevant stock exchange. This would inform management about the same, has **not** been incorporated in the Companies Bill (2009).

## 2.3 Penalties for violations

It has been often said that even when rules and regulations are adequate, the penalty levels for contravention of rules are so low that they fail to act as effective deterrents to their contravention. In the existing Companies Act of 1956, the penalty on companies and the relevant officers was rupees five hundred, and that on the auditor was rupees one thousand and that too for only willful default! (Sections 232 and 233)

The Companies Bill (2009) addresses this issue by mandating much stiffer punishment for any violation of the rules governing the audit process. It provides not only monetary penalties but also imprisonment. Under Section 130 of the Bill, any contravention of the auditing rules by the company attracts fines ranging from rupees twenty five thousand to rupees five lakhs. If an officer is in default, the fines range between rupees ten thousand to rupees one lakh and imprisonment up to one year. Penalties for auditor range between twenty five thousand to five lakh and for willful contravention, the penalties could be as high as rupees twenty five lakh with up to one year in imprisonment. In addition the auditors are required to refund

[15] Accounting and auditing standards in India are notified by the Central Government based on the recommendations of the National Advisory Committee on Accounting and Auditing Standards. The "Advisory Committee" prepares its recommendations in consultation with the Institute of Chartered Accountants of India (ICAI). In cases, where accounting standards for certain items are yet to be notified by the Central Government, the standards specified by the ICAI are deemed to be the auditing standards.

the remuneration received and, more importantly, pay for damages to the company or to any other persons for loss arising out of incorrect or misleading statements in the audit report.

## 2.4 Independent Oversight of the Auditors

The SOX Act has set up the Public Companies Accounting Oversight Board (PCAOB) "To oversee the audit of listed companies in order to protect investors' and public interest in matters relating to the preparation of audited financial statements."[16] The SOX Act empowers the PCAOB to register all audit firms, establish auditing rules, conduct periodic inspection of audit firms, carry out investigation and disciplinary proceedings against errant firms and ensure compliance with all the accounting and auditing rules specified under the SOX Act and the SEC rules.

The NCC reviewed the necessity of establishing a Public Oversight Board in line with the PCAOB, but ultimately did not recommend its establishment largely keeping in view that its establishment requires the consolidation of powers which are now distributed among the various regulatory authorities like the Department of Company Affairs (DCA), the SEBI, the Reserve Bank of India (RBI) and the like into a single regulatory body which is impractical. Instead, the NCC provided for the establishment of independent Quality Review Boards (QRBs), "to periodically examine and review the quality of audit, secretarial and cost accounting firms, and pass judgement and comments on the quality and sufficiency of systems, infrastructure and practices." The main objective behind the recommendations was to speed up the investigation and adjudication process, of complaints received against errant member firms, while keeping the process out of conflict with the provisions of the existing Acts. To this extent, the committee detailed out an elaborate institutional structure consisting of a "Prosecution Directorate", "Disciplinary Committee" and an appellate body which were responsible for timely disposal resolution of the various stages of a disciplinary process. It is hoped that the QRBs will further strengthen the integrity of the financial reporting process by requiring auditors to be more vigilant in the discharge of their functions.

[16] `http://www.sec.gov/rules/final/33-8183.htm`

# 3 Audit committee

The audit committee plays a vital role ensuring the independence of the audit process. Auditing the operations of modern corporations is a complex process requiring understanding of the rules and judgements made by the management in preparing the financial statements. For verification of these financial statements, the auditor requires access to all necessary documents and a truthful explanation of all procedures. It is unlikely that this can be expected from the inside management whose very actions is the subject of the auditing process. Even if management is truthful, there is a need to insulate the verification process from the influence of the inside management so that outsiders perceive the audit process as independent as they cannot directly observe the managers truthfulness. If auditors are hired by the management and they decide the scope of auditing services and auditor's compensation, the audit process is unlikely to be perceived as independent.

The audit committee has been formed to act both as a conduit of information supplied by the management to the auditors, and at the same time to insulate the auditor from the pulls and pressures of the management. The audit committee is therefore required to be "independent" of the management and has the responsibility of deciding the scope or work, including the fixation of audit fees and determination of the extent of non-audit services. The basic idea is to make the auditor not to be dependent on inside management, both in it terms of discharge of its functions as well as in terms of its survival.

## 3.1 Size and composition of the audit committee

There is a concerted move across all countries to require listed companies to have an audit committee of a minimum size, to ensure that members are financially literate and to make them independent of the management (see Box 3.1 and 3.1). In India, the constitution of audit committees is now mandatory for listed companies both under the Companies Bill (2009) as well as under Clause 49[17] of the SEBI Act. Section 158 of the Companies Bill (2009) requires all listed companies to have an audit committee with a minimum of three directors with independent directors forming a majority and at least one director having knowledge of financial management, audit or accounts. The chairman of the audit committee has to be an independent

[17] Securities and Exchange Board of India (SEBI), Clause 49 Regulations, Circular No. SEBI/CFD/DIL/CG/1/2004/12/10 October 29, 2004. http://www.sebi.gov.in

**Box 2: Cross-country comparison of regulations governing audit committees: OECD**

**NYSE Listing Standards, 2004 (USA):** Listed companies must have an Audit Committee. The audit committee must have a minimum of three members. All members of the audit committee must satisfy the requirements for independence. Each member of the audit committee must be financially literate, and at least one member of the audit committee must have accounting or related financial management expertise.

**Corporate Governance Principles and Recommendations, 2007 ASX Corporate Governance Council:** The board should establish an audit committee. The audit committee should be structured so that it consists only of non-executive directors; consists of a majority of independent directors; is chaired by an independent chair, who is not chair of the board; has at least three members. The audit committee should be of sufficient size, independence and technical expertise to discharge its mandate effectively.

**The Combined Code on Corporate Governance, 2003 (UK):** The board should establish an audit committee of at least three members (or in the case of smaller companies two) who should all be independent non-executive directors. The board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience.

**OECD Principles of Corporate Governance, 2004** When committees of the board are established, their mandate, composition and working procedures should be well defined and disclosed by the board. In order to evaluate the merits of board committees it is therefore important that the market receives a full and clear picture of their purpose, duties and composition.

director. The company is required to disclose the composition of the audit committee in its Director's Report.

Under Clause 49, all listed companies are required to have an audit committee of at least three directors of which two thirds should be independent. Clause 49 also requires the audit committee to meet at least four times a year with the gap between two successive meeting not exceeding four months. This regulation tries to ensure the quality of audit committee by requiring that all audit committee members to be "financially literate" with at least one member having "accounting or related financial management expertise."

The regulations regarding size, composition, and expertise under Clause 49 mirrors the New York Stock Exchange (NYSE) regulations in many respects,

**Box 3: Cross-country comparison of regulations governing audit committees: Emerging markets**

**Clause 49 of stock exchange Listing Agreement, 2004, SEBI (India):** All listed companies should have a Audit Committee. The audit committee shall have minimum three directors as members. Two-thirds of the members of audit committee shall be independent directors. All members of audit committee shall be financially literate and at least one member shall have accounting or related financial management expertise. The Chairman of the Audit Committee shall be an independent director.

**Guidelines of Code of Best Practice of CG, 2003, IBGC (Brazil)** The Audit Committee should preferably be made up of independent members of the Board of Directors. Directors also serving as Officers should not take part in the Audit Committee. The Board of Directors should provide a formal description of the qualifications, efforts, and time commitment expected from the Audit Committee. The Committee should set up its own Internal Regulation and consist of at least three members, all of whom familiar with basic financial and accounting matters. At least one member should be more experienced in accounting issues, audits, and financial management.

**Code on Corporate Governance Practices, Main Board Listing Rules, 2005, HKEx, (Hong Kong):** Every listed issuer must establish an audit committee comprising non-executive directors only. The audit committee must comprise a minimum of three members, at least one of whom is an independent non-executive director with appropriate professional qualifications or accounting or related financial management expertise as required under rule 3.10(2). The majority of the audit committee members must be independent non-executive directors of the listed issuer. The audit committee must be chaired by an independent non-executive director.

**Code of Corporate Governance, 2005, (Singapore):** The Board should set up an Audit Committee (AC). The AC should comprise at least three directors, all non-executive, the majority of whom, including the Chairman, should be independent. The Board should ensure that the members of the AC are appropriately qualified to discharge their responsibilities. At least two members should have accounting or related financial management expertise or experience, as the Board interprets such qualification in its business judgement.

but there are two important differences. Like Clause 49, Section 303A.07[18] of the NYSE regulations also require the audit committee to be have a minimum of three members, but under the NYSE regulations the audit committee is to be constituted entirely of independent directors unlike the two-thirds rule under Clause 49. Second, the NYSE regulation actively discourages

[18]NYSE Stock Exchange, Listed Company Manual, `http://nysemanual.nyse.com/lcm/`

audit committee members to serve in more than three audit committees and require that the company make an affirmative determination of the ability of an audit committee member to effectively discharge his/her responsibilities in case he/she serves in more than three audit committees. The company is required to disclose the basis of such determination in the company's proxy statement or annual report. No such affirmative determination is required under Clause 49.

The NCC committee expressly pointed to the considerable amount of additional time that an Audit Committee requires "to successfully discharge its obligations in letter and in spirit." This observation acquires special significance due to the high incidence of multiple directorships in India (Sarkar and Sarkar, 2009) and the fact that many companies belonging to business groups have multiple subsidiaries which demand significant amount of time by audit committee members to oversee the preparation of consolidated accounts. Section 146 of the Companies Bill (2009) does limit the number of directorships to fifteen. Clause 49 restricts the number of committee memberships to ten and the number of Chairmanship to five that directors can have in public limited companies. However, no separate restrictions exist for directors serving on audit committees. Indeed even the above restrictions are considered to be liberal to allow the directors to fully discharge their functions and responsibilities.

Another area which needs tightening in Clause 49 is the definition of "financially literate" and the conditions under which a member will be considered to have "accounting or related financial management expertise." Currently, these are too broad and open ended. As the NCC points out, while "While one member of the committee may be positioned as the one having "financial and accounting knowledge", it is worth asking how deep that knowledge is, especially given the new accounting standards and complexities". To be fair, the NYSE regulations which also have exactly the same requirements, does not even define these terms but instead gives the board the ultimate power to determine if in its business judgement, the qualification of a person is satisfactory enough to induct him/her as an audit committee member. A much tighter definition of financial expertise comes from the "SK Regulations" (See Box 3.1) in the United States which requires all companies filing financial statements with the SEC to declare if their audit committees contain an "audit committee financial expert". The regulations specify four attributes which a person must possess to qualify as an "audit committee financial expert" and list four alternative ways in which

**Box 4: Definition of "audit committee financial expert" under S-K Regulations**

SEC rules: Item 401 of Regulations S-K define an "audit committee financial expert" as a person who has the following attributes:

1. An understanding of generally accepted accounting principles and financial statements.
2. The ability to assess the general application of such principles in connection with the accounting for estimates, accruals and reserves.
3. Experience preparing, auditing, analysing or evaluating financial statements that present a breadth and level of complexity of accounting issues that are generally comparable to the breadth and complexity of issues that can reasonably be expected to be raised by the registrant's financial statements, or experience actively supervising one or more persons engaged in such activities.
4. An understanding of internal controls over financial reporting.
5. An understanding of audit committee functions.

Further, a person shall have acquired such attributes through:

1. Education and experience as a principal financial officer, principal accounting officer, controller, public accountant or auditor or experience in one or more positions that involve the performance of similar functions.
2. Experience actively supervising a principal financial officer, principal accounting officer, controller, public accountant, auditor or person performing similar functions.
3. Experience overseeing or assessing the performance of companies or public accountants with respect to the preparation, auditing or evaluation of financial statements; or
4. Other relevant experience.

these attributes must have been acquired by such a person.[19] The Clause 49 regulations, moving a step forward from the NYSE regulations, make an attempt to put some guidelines for defining what qualifies a member as having "accounting or related financial management expertise" but these are well short of the S-K definition.

[19] http://www.sec.gov/rules/final/33-8177.htm

## 3.2 Role and power of the audit committee

In addition to the size, composition and the expertise of the audit committee members, Clause 49 specify detailed guidelines regarding the role and powers of the audit committee. These regulations are mirrored in Section 158 of the Companies Bill (2009). Under Clause 49, the role of the audit committee is to provide oversight of the company's financial reporting process and ensure the credibility, correctness and the sufficiency of the disclosure that are required under the Companies Act of 1956, and the various stipulations specified by SEBI. The audit committee is also responsible for recommending to the Board regarding the appointment, re-appointment, and if required, the removal of the statutory auditor, and fixing the audit fees. The audit committee also has the responsibility of approving all non-audit activities of the statutory auditors and the fixation of the non-audit fees. The audit committee is required to review with the management the annual financial statements before submission to the Board for approval especially with respect to changes in accounting policies, audit qualifications, significant adjustments arising out of auditor findings, major accounting entries based on judgements made by management, disclosure of related party transactions and audit qualifications. Clause 49 also gives powers to the audit committee to investigate into any matter that is included in its terms of reference, seek any information from any employee, and to obtain external legal or professional advice that it considers necessary.

A significant number of proactive regulations have been enacted in India since the 1990s. For first time the Companies Amendment Bill of 2000 made the formation of audit committees mandatory for all companies with paid up capital of Rs. 5 crores. Clause 49 that was first notified in February 2000, reiterated this requirement for all listed companies. It required the formation of audit committee and specified its roles and functions. The amended version of Clause 49 that was notified in October 2004 detailed out the role, power and functions of the audit committee. The Companies Bill (2009) has also listed down the power and functions of the audit committee which were not specified under the Companies Act of 1956. But two aspects that require further attention are the composition of the audit committee and its authority to implement its decisions. These two aspects together affect the independence of the audit committee and its effectiveness in ensuring the integrity of the financial reporting process.

## 3.3 Dilution of audit committee independence

A review of the sequence of regulations shows that there has been a steady dilution of the impendence requirement with respect to the audit committee. The original Clause 49 regulations required the audit committee to have a minimum size of three and to be e constituted entirely of non-executive directors with majority of them being independent.[20] The revised Clause 49[21] removed the non-executive director requirement and instead specified that the audit committee to have a minimum of three members with two-thirds of them being independent. Given the specification of a minimum size of three, the move from the majority to the two-thirds rule did not impose any extra independence burden.[22] The only effect of the revised Clause 49 regulations was that management directors could now be part of the audit committee. The Companies Bill, 2009 follows the revised Clause 49 regulations by not insisting that the audit committee comprise only of non executive directors but reverts to the majority rule form the two-thirds rule.[23]

If the idea of allowing management presence in the audit committee is to get management input into the financial reporting process, then the same be easily obtained as elsewhere Clause 49 specifically empowers the audit committee can invite any of the executives, as it considers appropriate to be present at the meetings of the audit committee. The overwhelming objective of the regulations with respect to the audit committee should be to ensure that the audit committee is truly independent of the management. Seeking management input should be a discretionary choice of the committee and not mandated by law.

The NCC in its report, while applauding the existing Clause 49 regulations on the audit committee, pointed out that one area that needed improvement and tightening was the composition of the audit committee and recommended that if the audit committee is perceived to be independent, then it should

[20] Securities and Exchange Board of India (SEBI), Clause 49 Regulations, Circular No. SMDRP/POLICY/CIR-10/2000, dated February 21, 2000. `http://www.sebi.gov.in`

[21] Securities and Exchange Board of India (SEBI), Clause 49 Regulations, Circular No. SEBI/CFD/DIL/CG/1/2004/12/10 October 29, 2004. `http://www.sebi.gov.in`

[22] For an audit committee size of 3, 4 and 6 the two requirements are effectively the same. For size 5 only the modified would require 4 independent directors as opposed to 3 under the previous regulations. For audit committees of size seven or more, the modified regulations would require more independent directors, but very few companies have audit committees with more than seven or more members.

[23] Section 158 (2) of the Companies Bill, 2009 specifies that "The Audit Committee shall consist of a minimum of three directors with independent directors forming a majority and at least one director having knowledge of financial management, audit or accounts."

consist only of independent directors. Unfortunately this has not been incorporated in the Companies Bill (2009). In a situation where regulations all over the world are trying hard to increase investor confidence in the financial reporting process by envisaging an audit committee that is perceived as a body independent of the management (Boxes 3.1 and 3.1), regulations in India seem to be falling behind.

The lower independence requirement regarding the composition of the audit committee has to be seen in context of the fact that the audit committee's recommendations relating to hiring, oversight, compensation, and firing of the outside auditor are not binding on the Board. While Clause 49 is silent on this matter, Section 158 (9) of the Companies Bill (2009) (and currently under Section 292-A of the Companies (Amendment) Act, 2000) states if the Board does not accept the recommendations of the audit committee, reasons therefore should be communicated to shareholders.[24] This is quite in contrast to the regulation in the US where under the SOX Act of 2002, implemented by SEC under Rule 10A-3, the audit committee is "directly responsible for the appointment, compensation, retention and oversight" of the statutory auditor and each such statutory auditor "must report directly to the audit committee."

The power of the Board to overrule the decision or recommendations of the audit committee has to be also seen in context of the current Clause 49 regulations governing Board independence. Clause 49 allows the Board to have only one-third independent directors in case of a non-executive Chairman. Allowing the Board to overrule the recommendations of the audit committee brings in the possibility of management overrule as the Board will be dominated by insiders in this case. Even in the case of a board with an Executive Chairman, where Clause 49 regulations require independent directors to consist of at least fifty percent, the strength of the inside directors is evenly poised with that of the independent directors

[24] Recommendation 4.7(11) of the Sanjeev Reddy Report on Corporate Excellence (2000) commissioned the Department of Company Affairs which forms the basis of the 2000 Amendment states that the audit committee being the creature of the Board "should be subordinate to the authority of the Board. The Board should have the authority to override any decisions of the Committee. In the interests of the professionalism and transparency, where the Board disagrees with any material decision of the Audit Committee, there should be a disclosure requirement in the annual reports to set out any such instances together with the reasoning of the Board for such decisions." Similar recommendations are found in the J.J Irani Committee Report on Company Law which forms the basis of the Companies Bill (2009) which states that "The recommendation of the Audit Committee if overruled by the Board, should be disclosed in the Directors' Report with the reasons for overruling."

and possibly tilted towards the management as the Chairman is an insider. Under the Companies Bill (2009), this problem will be further aggravated as the proposed regulation with respect to board composition require companies to have only a minimum of one-third of the board to consist of independent directors and does not make any distinction between companies with executive and non-executive status of the Chairman.[25]

Ensuring the integrity of the financial reporting process by providing independent oversight by the audit committee is paramount for governance. The SOX regulations try to ensure this by requiring the audit committee to consist entirely of independent directors and giving it the sole authority to discharging all audit-related functions. The SOX Act has no role for independent directors apart from serving in the audit committee. The NYSE listing regulation provide for a majority independent Board to oversee the overall running of the company. Together they provide an environment for more independent reporting of the numbers. In India in contrast, the audit committee is much more subject to the influence of the management. The power of the Board to overrule the recommendations of the audit committee and the current regulations governing Board composition makes the audit committee in India less powerful and more subjected to the influence of the management than it is in the US.

While Clause 49 has details specifications regarding the powers, role and review of the audit committee, it does not formally require the preparation of an audit committee report as required under the SEC regulation. The *Quarterly Compliance Report* stipulated under Clause 49 only require the company to report the compliance status (reported as "yes" or "no") with respect to the various aspects of audit committee functioning which amounts to tick box regulation. The suggested items for inclusion in the *Annual Corporate Governance Report* with respect to audit committees only require the company to give a brief description of the terms of reference, composition, including name of members and chairperson, along with meetings and attendance of the audit committee during the year.

The NCC recommended that the role and functions of the audit committee be laid down in an *Audit Committee Charter* and recommended that the chairman certify whether the audit committee discharged all the functions listed in an audit committee charter which would form the *Action Taken Report* to shareholders (ATR). The NCC further recommended that the statement should also certify whether the audit committee met with the statutory and internal auditors, without the presence of management, and

[25]Section 132(3) of the Companies Bill (2009).

whether such meetings revealed materially significant issues of risks. The NYSE regulations are clear is specifying that for the audit committee "to perform its oversight functions most effectively, it must have the benefit of separate sessions with the management, the independent auditors and those responsible for the internal audit function." Currently, Clause 49 regulations do not specifically require the audit committee to meet separately the external auditor and the internal auditor, and without the management to get an independent assessment of the internal audit procedure. Similar requirements are also not included in the Companies Bill (2009).

The general tone of the SEC regulation is that the audit committee is a body that is independent of the management and works closely with the external auditor to ensure that the management justifies all critical accounting policies and practices that it uses in preparing the financial statements. The NYSE rules specifically state that one of the duties and responsibilities of the audit committee is to "review with the independent audit any audit problems or difficulties and management's response."

In contrast, under Clause 49, the audit committee reviews "with the management" the financial reporting process and evaluates the performance of the internal and external auditors which gives the notion of a teamwork of which the management, the internal auditors, the audit committee and the external auditors are equal partners. This probably reflects the philosophy of "self governance" and the often made assertion that "compliance should come from within". Only time will tell which approach is more justified.

# 4 Effectiveness of audit committees and auditor independence: empirical evidence

Audit committee and auditor independence have been important areas of research in the accounting literature. Studies on audit committees have focused on the independence, activity, and on the financial expertise of the audit committee members. Research on auditor independence have focused on the extent of non-audit services provided by the external auditor as well audit firm tenure, both of which are generally seen as hindrances to auditor independence. Renewed interest on these topics have emerged in light of the new regulations that were enacted in the wake of the major corporate scandals in the US, particularly the collapse of WorldCom and Enron and the consequent enactment of the SOX regulations. The SOX regulations have

been a reference point of similar reforms initiated in many other countries relating to audit committees and auditor independence. The SOX regulations emphasize not only the independence but also the financial expertise of the audit committees. Similarly the SOX regulation and the recent provisions of the new Companies Bill 2009 in India prohibit a number of non-audit services which are conceived to be a hindrance to auditor independence.

The extant literature provides strong empirical support that both independent audit committees and higher levels of audit independence have a significant beneficial effect on enhancing the quality of disclosures, in reducing discretionary earnings management, increasing the informativeness of earnings, and in general enhancing the value of the firm.

## 4.1 Studies on audit committees and earnings management

Earnings management occurs when managers use judgement in financial reporting and in structuring transactions to alter financial reports to either mislead some stakeholders about the underlying economic performance of a company or influence contractual outcomes that depend on reported accounting numbers (Healey and Wahlen, 1999).

A number of empirical studies have looked at the relation between audit committee independence and earnings management. The study by (Klein, 2002) which analyses the relation between audit committee and board characteristics and earnings management using a two year sample of 500 S&P firms, finds that independent audit committees significantly reduced abnormal accruals as did an independent boards. Reductions in audit committee independence are accompanied by large increases in abnormal accruals. The effect is most pronounced when the board or the resultant audit committee is comprised of a minority of outside directors i.e., when audit committee changes from majority to minority of independent directors.

Carcello *et al.* (2002) used a sample of 100 *Fortune-500* companies to examine if a more independent audit committee tries to protect its reputation by insisting on differentially higher audit quality. The authors hypothesize that this should lead to the demand for higher audit effort and consequently to the hiring of high quality auditors. Consistent with this conjecture, the study finds a positive relation between audit fees and audit committee independence, diligence, and expertise.

Abbott *et al.* (2003) addresses issues relating to auditor-client independence using a sample of 538 companies for the year 2001. Rendering of certain types of non-audit services is perceived by regulators as hampering auditor independence. Independent audit committees may have incentives to limit non-audit services and accordingly, non-audit fees, to enhance auditor-independence in either appearance or fact. The study finds that active and independent audit committees, consisting of fully independent directors and meeting at least four times a year, are associated with significantly lower non-audit fee ratio. The evidence is consistent with the general perception that high level of non-audit fees could act as a hindrance to auditor independence.

Many studies examine whether the financial expertise of the audit committee matters in increasing the quality of accounting disclosures. For example, Yeh and Woidtke (2007) examine the effect of concentrated ownership, independence of the audit committee and the presence of financial expertise on earnings informativeness. Earnings informativeness measures how stock market returns respond to changes in measures of accounting performance. The study is based on a sample of 450 observations consisting of the largest 150 companies each from three East Asian countries namely, Singapore, Hong Kong and Malaysia. The study finds that concentrated ownership reduces earnings informativeness. However, independent audit committees enhance earnings informativeness only if there are independent directors in the audit committee with financial expertise. In addition, the positive benefits of having an independent audit committee along with directors having financial expertise more than offset the detrimental effect that is associated with concentrated ownership.

Similarly, Xie *et al.* (2003) using a sample of 110 firms from the S&P 500 for three years, 1992, 1994, and 1996, show that audit committees with members having corporate or financial backgrounds are associated with lower earnings management. Similar results are found for frequency of meetings by the audit committee. The study shows that it is not independence per se but the quality and activity of the audit committee which is important.

## 4.2 Studies on auditor independence and earnings management

Auditor independence has been another area of intensive research in the accounting literature. Auditor independence has been generally proxied by the ratio of non-audit to audit fees under the assumption that a relatively

higher non-audit fee makes the auditor more dependent on the company for its economic survival and hinder and comprise its ability to fully and faithfully discharge its audit related functions. Accordingly, studies in this genre have looked at the effect auditor independence on earnings management, earnings informativeness, and other measures of earnings quality.

Frankel *et al.* (2002) examine whether auditor fees are associated with earnings management and how the market reacts to the disclosure of auditor fees. Using data collected from proxy statements, they find that non-audit fees are positively associated with small earnings surprises and the magnitude of discretionary accruals, while audit fees are negatively associated with these earnings management indicators. They also find evidence that share values of firms which reported higher ratios of non-audit fees too audit fees were lower on the date the fees were disclosed, although the effect is small in economic terms.

In related work, Srinidhi and Gul (2007) explore the relation between non-audit fees and accrual quality to analyse if in settings where audit quality is compromised by a loss of auditor independence, managers used accruals more opportunistically and thereby drive down the accrual quality. They also examined if higher audit effort and quality as which are proxied by higher audit fees translate into better accrual quality. Their results show that accrual quality has a significant negative association with the magnitude of non-audit fees and a significant positive association with audit fees. However, not all studies tend to find evidence that non-audit fees are associated with biased financial reporting (Huang *et al.*, 2007).

It is difficult to compare findings of studies from different countries as the ratio of non-audit to audit fees is only a proxy of auditor independence which can also depend significantly on the institutional and legal framework of the respective countries, and in particular on its accounting standards and punitive actions in case of accounting violations.

## 4.3 Studies on auditor rotation and earnings management

The issue of audit independence and audit firm rotation has been highly debated in the accounting literature. As mentioned earlier, the debate highlights two opposing perspectives with the proponents emphasizing the need to have a "fresh look" at periodic intervals to ensure client-auditor

independence and auditor efficiency while the opponents highlighting the risk of lower audit quality and higher audit failures that can occur due to the loss in continuity and audit competence created by mandatory audit firm rotation (Hoyle, 1978). Academic studies till date have not been able to produce conclusive proofs about the benefits of audit firm rotation while there are good evidences of the risks.

For example, Myers *et al.* (2003) find that earnings quality is actually lower in firms with shorter audit tenure. They interpret their results as suggesting that longer auditor tenure results in auditors placing greater constraints on management decisions in the reporting of financial performance. Other research indicate that a greater proportion of audit failures occur with newly acquired clients (Berton, 2007; Petty and Cuganesan, 2006) and that auditors' litigation risk is higher in the initial years of audit engagement (Palmrose, 2006).

One problem with these empirical studies is that they cannot test if rotating auditors will enhance audit quality as very few companies have in practice rotated auditors since the law does not require then to do so. Most of the empirical findings cited above use length of audit tenure in their analysis and then extrapolate their findings to the case of zero tenure i.e., auditor rotation. However, this may not be the correct approach as auditor rotation is a discrete event and may not be predictable from these models which treat tenure as continuous.

Notwithstanding the findings of the empirical studies, theoretical arguments imply that there ought to be term limits for auditors or at least the audit engagement team. Surely, longer tenure is better in that the understanding of auditor of the internal workings of the companies increase with it. But longer the tenure, higher is the risk of management influence on the auditor. Thus there ought to be some point where rotating auditors or audit partners would result in higher net benefits.

# 5 Trends in audit committee and auditor characteristics in India

This section presents trends in characteristic of audit committees, their size, composition, and activity as well as extent of non-audit services provided by auditors in Indian companies.

These trends are presented for the period 2005 to 2008 based on a balanced panel of the top 500 listed companies[26] in India terms of market capitalization as on March 31st, 2008. Table 1 presents trends in audit committee size. This table and all subsequent ones are constructed based on the disclosures made in the corporate governance reports filed by the companies. The year 2006 marks the year when all listed firms were required to comply with the revised provisions of Clause 49 which were first notified on October 29, 2004 but came into effect from January 1, 2006.

**Table 1** Distribution of firms according to size of audit committees

| Size | 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|
| 2 | 0.30 | 2.19 | 0.51 | 1.25 |
| 3 | 57.19 | 50.27 | 51.39 | 49.87 |
| 4 | 29.64 | 33.61 | 34.43 | 36.84 |
| 5 | 7.78 | 9.02 | 9.87 | 8.02 |
| 6 | 2.99 | 3.83 | 3.04 | 3.26 |
| 7 | 2.10 | 0.55 | 0.51 | 0.50 |
| 8 | 0.00 | 0.27 | 0.00 | 0.25 |
| 9 | 0.00 | 0.27 | 0.25 | 0.00 |
| Average | 3.62 | 3.66 | 3.66 | 3.62 |
| No. of firms | 334 | 366 | 395 | 399 |

Source: Annual Reports of Companies, SANSCO

Judged in the context of Clause 49 regulations requiring listed companies to have audit committees with a minimum of three members, Table 1 shows that nearly all companies have complied with the regulation.

A majority of the companies, however have constituted their audit committees with the minimum size required under the regulations, with one third of the companies adding one extra member. There are very few companies that have audit committees with more than five members. Tables 2 and 3 show the trends in audit committee independence.

Recalling that Clause 49 requires all audit committees to have at least 2 to 3 of its members as independent directors, Table 2 shows that the mean of independent directors to be around 80 in these four years. Notwithstanding this observation, about 15 percent of the companies did not comply with the regulations in 2006. However, companies seem to be making an effort to comply with the regulations with the extent of non-compliance decreasing to just over 10 percent by 2008.

[26]Financial firms are excluded from the analysis.

**Table 2** Trends in audit committee independence: Distribution of companies

| Fraction of Ind. Directors | Year 2005 | 2006 | 2007 | 2008 |
|---|---|---|---|---|
| $f < 2/3$ | 8.16 | 15.32 | 12.76 | 10.35 |
| $2/3 \leq f < 3/4$ | 18.43 | 18.11 | 22.45 | 23.48 |
| $3/4 \leq f < 1$ | 18.43 | 22.84 | 25.51 | 28.28 |
| $f = 1$ | 54.98 | 43.73 | 39.29 | 37.88 |
| Companies (number) | 334 | 366 | 395 | 399 |
| Fraction of Ind. Directors | 0.85 | 0.78 | 0.78 | 0.79 |
| Fraction with Managing Director in the audit committee (%) | 19.51 | 19.70 | 19.90 | 22.47 |

Source: Annual Reports of Companies, SANSCO

A striking observation with regard to audit committee independence is the steady decline in the percentage of companies with fully independent audit committees. While in 2005 more than half of the companies had voluntarily chosen to have a fully independent audit committee, this percentage has steadily declined to just over one-third by 2008. What is instead observed is a very steady move to have audit committees which are just in accordance with the minimum independence requirement that is prescribed under the law.[27]

This is further borne out by the steady increase in the proportion of companies that have an executive (management) director present in audit committees from 2006 to 2008. Recall that until 2006, when the revised Clause 49 same into effect, the audit committee was required to consist only of non-executive directors. The revised Clause permitted executive directors to be part of the audit committee and what we observe since then is a change in audit committee composition that seems to be a direct response to the change in regulation. The steady decline in fully independent audit committees is also consistent with this change in regulation as non-executive directors are more likely to be also independent directors.[28]

The trends in independence presented in Table 3 for different sizes of audit committees confirm that the decline in fully independent audit committees is true for of all sizes though the decline is more pronounced for audit

[27]Given the size distribution of audit committees in Table 1, a fraction between 2/3 but less than 1 implies a mandatory compliance under the Clause 49 regulations.

[28]Non-executive directors could be independent directors or gray directors. Gray directors are those who are related to the executive directors or have a financial interest in the company. Companies belonging to business groups often have family members serving as gray directors on company boards.

**Table 3** Trends in audit committee independence: Distribution of companies

The following tables describe the fraction of independent directors on the audit committees of companies in India as a measure of audit committee independence, and how this has changed in the period from 2005-2009 for Indian companies. This is shown for companies with different sizes of audit companies, where the size $= 3, 4, 5, 6$.

| Fraction of | Size=3 | | | | Size=4 | | | |
|---|---|---|---|---|---|---|---|---|
| Independent Directors | 2005 | 2006 | 2007 | 2008 | 2005 | 2006 | 2007 | 2008 |
| $f < 2/3$ | 7.41 | 7.73 | 8.50 | 6.53 | 6.06 | 15.97 | 10.29 | 9.72 |
| $2/3 \leq f < 3/4$ | 28.04 | 32.04 | 39.50 | 42.21 | 0.00 | 0.00 | 0.00 | 0.00 |
| $3/4 \leq f < 1$ | 0.00 | 0.00 | 0.00 | 0.00 | 48.48 | 52.10 | 61.76 | 62.50 |
| $f = 1$ | 64.55 | 60.22 | 52.00 | 51.26 | 45.45 | 31.93 | 27.94 | 27.78 |
| No. of Firms | 189 | 181 | 200 | 199 | 99 | 119 | 136 | 144 |
| | Size=5 | | | | Size=6 | | | |
| | 2005 | 2006 | 2007 | 2008 | 2005 | 2006 | 2007 | 2008 |
| $f < 2/3$ | 23.08 | 30.30 | 38.46 | 31.25 | 11.11 | 28.57 | 16.67 | 15.38 |
| $2/3 \leq f < 3/4$ | 0.00 | 0.00 | 0.00 | 0.00 | 33.33 | 35.71 | 58.33 | 61.54 |
| $3/4 \leq f < 1$ | 50.00 | 51.52 | 38.46 | 59.38 | 0.00 | 21.43 | 8.33 | 15.38 |
| $f = 1$ | 26.92 | 18.18 | 23.08 | 9.38 | 55.56 | 14.29 | 16.67 | 7.69 |
| No. of firms | 26 | 33 | 39 | 32 | 9 | 14 | 12 | 13 |

Source: Annual Reports of Companies, SANSCO

committees which are bigger in size. The bigger audit committees also have higher non-compliance with the Clause 49 requirements. For example, in 2008, almost one third of the audit committees with size 5 did not have the requisite number of independent directors required under Clause 49.

Table 4 presents the distribution of companies according to the number of meetings held. Clause 49 requires the audit committee to have at least 4 meetings per year with not more than four months of gap between two successive meetings. It can be observed that there is steady improvement in compliance with only about 5 percent of the companies holding less than four meetings in 2008. The mean number of meetings held is nearly five in the last two years. It appears that many companies are holding meetings as per their individual requirements and were not simply following the dictates of the law.

However, an important issue with respect to meetings is the duration of the audit committee meetings and the preparation time that is given to the audit committee members to have meaningful discussions about the financial operation of the companies. FICCI and Thornton (2009) conducted a a

**Table 4** Meetings Held by Audit Committees - Distribution of Companies

| No. of Meetings Held | Year | | | |
|---|---|---|---|---|
| | 2005 | 2006 | 2007 | 2008 |
| 0 | 0.93 | 0.56 | 1.03 | 0.50 |
| 1 | 0.62 | 3.36 | 1.28 | 0.25 |
| 2 | 2.17 | 1.96 | 1.28 | 1.01 |
| 3 | 11.46 | 6.16 | 3.59 | 4.52 |
| 4 | 39.94 | 43.14 | 44.10 | 45.23 |
| 5 | 24.46 | 23.81 | 25.13 | 26.88 |
| 6 | 9.91 | 11.48 | 12.31 | 11.31 |
| 7 | 10.53 | 9.52 | 11.28 | 10.30 |
| Avg. meetings held | 4.67 | 4.62 | 4.83 | 4.82 |
| Companies (number) | 323 | 357 | 390 | 398 |

Source: Annual Reports of Companies, SANSCO

corporate governance review of 500 mid-sized companies which show that, in 50 percent of the companies, audit committee meetings lasted for less than two hours while in only 9 percent of the companies did the meetings went beyond four hours. Similarly, the majority of the companies gave an average preparation time of up to seven days to the audit committee members in terms s of mailing them the agenda of the meetings while only 6 percent gave time of more than two weeks.

Additional characteristics of audit committees for the panel of 500 companies are presented in Table 5 for the year 2008, which presents key measures of audit committee quality that have been the focus of reform initiatives. Among these are (i) the presence of members with accounting degree (ii) the number of directorships held by independent directors (iii) the tenure of the independent directors and (iv) the mean age of independent directors serving on the audit committee. While audit committee independence is paramount for ensuring the integrity of the financial reporting process, there is a growing recognition that what is perhaps more important is the financial literacy and commitment of the audit committee members to discharge the various functions entrusted to them by the law. While Clause 49 does not require audit committee members to possess accounting degrees, it can be hardly imagined that a audit committee will be able to do justice to its role without any of its members having a formal training on the complexity of the accounting process and the various accounting and auditing standards that confront today's corporations.

Table 5 shows that about two thirds of the companies had an audit committee

**Table 5** Audit Committee Characteristics (Sample Means) - 2008

| | |
|---|---|
| Size of Audit Committee (Nos.) | 3.65 |
| Size of Board (Nos.) | 8.92 |
| Audit Committee has a member with an accounting degree (%) | 63.00 |
| Board has a member with an accounting degree (%) | 95.00 |
| Number of Audit Committee members with an accounting degree (Nos.) | 1.35 |
| Number of Board members with accounting degree (Nos.) | 2.78 |
| Percentage of Audit Committee members with an accounting degree (%) | 40.13 |
| Percentage of Board members with an accounting degree (%) | 31.82 |
| Total number of directorships of independent directors serving in the Audit Committee (Nos.) | 2.61 |
| Median tenure of independent directors serving in the Audit Committee (Yrs.) | 6.53 |
| Median age of independent directors serving in the Audit Committee (Yrs.) | 58.29 |

Source: Annual Reports of Companies, SANSCO
Directors Database: A Corporate Governance Initiative of Bombay Stock Exchange prepared in association with Prime Database. http://www.directorsdatabase.com/

with at least one member with an accounting degree. However, where the audit committee did not have a member with accounting knowledge it was very likely the Board had one such a member. On an average, forty percent of the audit committee members had an accounting degree. Another fundamental condition which need to be fulfilled by audit committee members is their ability to devote sufficient time to effectively discharge the all the functions assigned to them by law. As we have seen that the current SEC regulations discourage directors with more than three directorships to be members of the audit committee because over the commitment that comes with too many directorships might hamper the ability of the directors to dutifully carry out all the functions expected of him/her. In this context, it is encouraging to note from Table 5 that the average directorships held by independent directors to be less than three. This is a welcome development and will hopefully persist in the coming years.

Moving to issues relating to auditor independence, Table 6 presents some

**Table 6** Non-Audit services and non–audit fees

| | 2006-07 | 2007-08 |
|---|---|---|
| **Companies where auditors render non-audit services** | (%) | (%) |
| Indian Business Groups | 83.90 | 85.15 |
| Indian Standalone | 75.73 | 70.54 |
| Foreign Business Groups | 84.21 | 88.24 |
| Foreign Standalone | 70.37 | 62.96 |
| All Companies | 80.00 | 79.40 |
| **Non-audit to audit fees by ownership groups (median)** | (%) | (%) |
| Indian Business Groups | 42.00 | 34.88 |
| Indian Standalone | 39.54 | 26.30 |
| Foreign Business Groups | 53.92 | 56.38 |
| Foreign Standalone | 79.42 | 86.89 |
| All Companies | 46.67 | 35.65 |
| **Non-audit to audit fees by size (median)** | (%) | (%) |
| Small (< 750 crores) | 48.33 | 35.42 |
| Medium (> 750 and < 3400 crores) | 41.43 | 33.50 |
| Large (> 3400 crores) | 55.36 | 44.44 |
| All Companies | 46.67 | 35.65 |

Source: Annual Reports of Companies, SANSCO

relevant statistics for the same panel of 500 companies, but for the years 2007 and 2008. It can be observed that in eighty percent of the companies, the statutory auditor was also rendering non-audit services. There is virtually no change between 2007 and 2008. Comparative figures available for the US in 2000, which predates the passage of the SOX ACT, show that out of the 16700 companies which registered with the SEC, only 4100, or 25 percent purchased non-audit services from the external auditor.

Interesting differences surface when the aggregate picture is broken down into ownership groups. Nearly eighty five percent of companies belonging to business groups, either domestic or foreign buy non-audit services from the statutory auditor compared to seventy to seventy five percent for standalone firms. Second, the percentage of group companies buying non-audit services shows an increase from 2007 to 2008 while standalone companies exhibit a decline.

Table 6 also presents the extent of non-audit fees relative to audit fees earned by auditing firms. Current regulations require that non-audit fees not to exceed audit-fees. As the data in the table demonstrates, the extent of non-audit fees in both years was well below the statutory limit. More encouragingly, the extent of non-audit to audit fees has declined from 46.67

percent in 2007 to 35.65 in 2008. Decomposition by ownership groups shows that extent of non-audit fees to be much higher for foreign companies than for domestic companies. On an average, the ratio of non-audit to audit fees were around 40 percent in 2007 compared to 53 percent for foreign group companies and nearly 80 percent for foreign standalone companies. More strikingly, while domestic companies exhibit a decline in the non-audit fee percentage, with the decline more pronounced for standalone companies, foreign companies exhibit an increase, however marginal. Decomposition with respect to size shows that the extent of non-audit fees to be higher in the larger bigger companies for both years. However, all companies, irrespective of size, show a significant decline in non-audit fee percentage in 2008.

The above analysis of the empirical trends presents a mixed picture. On the one hand we observe an increasing trend in compliance. However, at the same time, we observe a tendency to gravitate to the minimum standards with respect to audit committee composition. There is little voluntary move to compose a fully independent audit committee. Instead what we observe is an increasing trend of inside management to being present in audit committees. Compared to this, the trends in auditor independence are better. The data with respect to non-audit services and extent of non-audit fees tend to suggest that domestic standalone companies, which are also likely to be relatively smaller in size, are very steadily moving towards the notion of auditor-company independence envisaged under the regulations. This is a very welcome development.

# 6 Conclusions

The theoretical arguments and the empirical literature overwhelmingly suggest that auditor and audit committee independence plays an important role in the governance of companies. Currently auditor independence in India, especially with respect to rendering non-audit services and presence of conflict of interest, is largely dependent on self regulation. The Companies Act of 1956 has little to offer in this regard. Under the existing regulations there are many governance issues with respect to auditor and audit committee independence in India. Among these, the most important ones are that (i) no regulation bars an auditor from having family or other close relationship with the audited company or its key management personnel; (ii) no cooling-off period for audit partners or staff to join audit clients in a senior management position or client personnel joining the audit firm; (iii) auditors can provide

non-audit services like tax planning, tax representation before tax authorities, due diligence certification, mergers and acquisition; (iv) no mandatory audit firm rotation except for government-owned companies, banks, and insurance companies; and (v) inside management can be present in audit committees.

The recommendations of the Naresh Chandra Committee have plugged many of these loopholes. The committee's recommendations especially with respect to auditor independence are in line with the best international practices. The Companies Bill (2009) has incorporated many of these recommendations. For investors to have confidence in the independence of the auditor, the Companies Bill (2009) needs to be enacted quickly into law.

However, notwithstanding the passage of the Companies Bill (2009), some issues that have not been incorporated into the Bill will remain as matter of concern. Most important among these are the independence of the audit committee both in terms of its composition and the power of the Board to overrule its decisions, and the issues related to conflict-of-interest in auditor-company relationship and audit partner rotation. These issues have to be addressed in future regulation to make the auditing and oversight standards in India comparable to those in the more mature economies. If it is operationally difficult to do further modifications to the statutes in the immediate future, then the respective stock exchanges should explore the possibility of incorporating these additional standards of independence in their Listing Agreement. Since the provisions of the Companies Bill (2009) can be interpreted as only laying down minimum standards nothing should prevent the stock exchanges from insisting on higher standards of independence from companies listed under their supervision.

In conclusion, adequate, relevant and high quality disclosures are one of the most powerful tools available in the hands of independent directors, shareholders, regulators and outside investors to monitor the performance of a company. This is particularly important for emerging economies like India where there is insider dominance. To this extent, measures that strengthen auditor independence and enhance the powers, functions, and the independence of the audit committee will be crucial in the governance of Indian companies. Governance risk is a key determinant of market pricing of listed securities. A high perceived 'independence quotient' of a company's auditing process can be reassuring to outside shareholders that can help reduce the risk premium of raising capital thereby providing a strong business case for strengthening auditor and audit committee independence.

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