



Boards: Guardians of Good Governance & Transparency

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Good evening every one.

The theme of today's Conclave is Top Trends for Building Tomorrow's Corporate Boards.

The theme is very relevant. We have just become the fifth largest economy of the World. How soon we can become 5 trillion economy will depend upon how private sector performs and how corporate boards re-invent themselves to drive such change.

In this context, I must say that the Corporate Boards and NFRA have lot of commonalities in their objectives. Both are supposed to promote and protect shareholders' interest and ensure good corporate governance. The only difference is that the directors and Independent directors are inside the company and NFRA works from outside the company. Both of us rely upon the institution of Independent Statutory Auditors.

Before I talk more on the roles of the corporate boards and the statutory auditors, let me talk a little bit about the historical evolution of the regulatory oversight over the functioning of the companies during last one century.

I will start with a famous case of 1920s. **Krueger and Toll case.** The mastermind of the Kreuger & Toll fraud was a Swedish engineer named Ivar. He had earned nickname 'Saviour of Europe' and 'Match-box King'. Reportedly, he controlled approximately 75% of the European and American match-box market. He also had a telephone company, the famous



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Ericsson, which had factories in 12 countries. During the 1920s, the company loaned hundreds of millions of dollars to cash-starved European governments to help them rebuild their war-torn economies. To raise these huge amounts, he set up an American subsidiary and began selling stocks and bonds to U.S. investors. He attracted them by paying dividends up to 20% annually. What began as a seemingly smart and innovative plan to dominate the world match-box market eventually became a "pyramid" or "Ponzi" scheme. Dividends were paid out of capital, and the money from subsequent loans and bond issuances were used to repay initial investors.

Krueger committed suicide in March 1932 in Paris. The financial loss to the investors was estimated to be in the range of US\$ 250 to 400 Million. This case helped build political support for passage of the U.S. Securities Acts 1933 an established SEC and the new law required companies to publish audited financial statements before selling securities to the public.

Another interesting case was reported during the same time. **McKesson & Robbins case.** The mastermind of the Robbins fraud was Philip Musica, an Italian immigrant, who was urged by prominent Republicans in 1937 to seek their party nomination for U.S. President against President Franklin Roosevelt. Musica was a criminal convicted of fraud twice. He was also a boot legger. In 1925, Musica under the assumed name of F. Donald Coster, M.D., Ph.D., used his bootlegging profits to buy McKesson & Robbins, a ninety-year-old company that sold milk of magnesia, cough syrup, etc. During the next twelve years, Musica/Coster built a pharmaceutical distribution network. To inflate McKesson & Robbins' reported assets while skimming cash into his own pocket, Musica enlisted the help of his three younger brothers, who were in-charge of fictitious sales agency companies.

The McKesson & Robbins fraud of 1939 led to significant changes in procedures. The SEC recommended that non-officer members of the client's board nominate the auditors and that auditors be elected by and address their report to the shareholders. That is the genesis of the institutions of Statutory Auditors and Independent Directors. Thereafter whenever major corporate failures took place, people had a chance to introspect. One such occasion was when Enron failed. Obviously, it was failure on the part of Enron Management. The question arose when the failures were brewing, what were the auditors doing. In that case the auditor was Arthur Anderson. The question also arose who is going to audit the auditors. That was the genesis of Sarbanes-Oxley Act and formation of PCAOB in 2003. Thereafter cue was taken by other countries like UK, Japan, Singapore, Canada, Australia formed audit and accounting oversight bodies in their countries.

India too faced several major corporate failures and scams - Harshad Mehta, Ketan Parikh, Satyam, ILFS, PNB, Neerav Modi. Investors, banks, and creditors lost thousands of crores of rupees. They shook the confidence of everyone in the financial figures reported by them. Questions arose here too when these scams were happening where managements were actively participating, what were the auditors doing? In India we had no institution which would challenge and audit these external auditors. In this back-drop Section 132 in the Companies Act was incorporated to set up NFRA. However, the section was not notified till 2018 when few more scams and corporate failures shook the country, NFRA was set up. Thanks to the crucial role played by **Mr. Srinivas Injeti**. He deserves one more felicitation for this.



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This was the story of how NFRA and institution of independent director came up. When I speak to my many friends who are non-executive and independent directors, I find that though they know their roles, responsibilities, and duties. Yet it is not very clear to them how exactly they can fulfil their responsibilities and ensure corporate governance. Schedule IV of the Companies Act says *Independent Directors satisfy themselves on the integrity of financial information and that financial controls and the systems of risk management are robust and defensible*. The questions is how? That is where role of the auditors becomes very critical.

The role of audit committees which has the majority of independent directors is also very crucial in ensuring the integrity of financial information of the company. Obviously other Directors will also have the same responsibilities.

Yet, whenever any major corporate failures or scams take place, there is a tendency to brand them as systemic failures. They say that in a large organization, if some fraud is being committed at some level, how will the board, the audit committees, directors or independent directors know about it? There is also a tendency to justify that these failures were not brought to their notice or discussed in the board meeting and therefore they cannot be held accountable. When the statutory auditor is asked about the failures, they tend to pass the buck by saying that there are millions of transactions in large company and they are not expected to verify each and every transaction. Another argument is that they are not forensic auditors. They are statutory auditors. This is a classic case of shifting of blames and when you cannot find any one and pass it as systemic failure.

In this context, it is necessary to look at the roles and responsibilities of board members including independent director. Again I quote from the Schedule IV of the Companies Act - It says, "Independent Directors should satisfy themselves on the integrity of financial information and existence of financial controls and risk management and seek appropriate

clarification or amplification of information and, where necessary, take and follow appropriate professional advice and opinion of outside experts at the expense of the company”.

Now look at the roles and responsibilities of an statutory auditor. In India we follow International Accounting Standards and as well as the Auditing Standards. Ind AS is mostly International standards with a few carve outs. Our Auditing Standard is same as the International Standards. Let us look at some important provisions there.

SA 200 and 240:

“Auditor shall maintain professional scepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance”.

SA 530 talks about Audit Sampling

A12.Because the purpose of sampling is to provide a reasonable basis for the auditor to draw conclusions about the population from which the sample is selected, it is important that the auditor selects a representative sample, so that bias is avoided, by choosing sample items which have characteristics typical of the population.

Related Party Transactions

Section 188 of the Companies Act, 2013, SA 540 and Ind AS 24 prescribe auditors' responsibilities and management responsibilities for RPTs. Schedule IV also requires the Independent Directors to scrutinize Related Party Transactions and see that they are in the interest of the company and shareholders. Auditors are required to challenge the management claim that they are at fair valuation and are at arms' length.

It is obvious from all these SAs and Provisions of the Company Law that the Auditors are duty bound to challenge management reports, draw sample transactions for verifications and scrutinize them. They can no more hide behind the excuse that management did not report the failures and they took the management in good faith. The failures of auditors to exercise due diligence and professional scepticism are viewed very seriously by International Regulators such as PCAOB, FRC etc.

In this context I also came across a recent article in ICAI journal by Mr. Y. H. Malegam, Past ICAI President and one of the titans of the auditing profession. He writes-

“Finding fraud can well become a major element of future audit reform. There is a growing expectation in the investing public and regulators that the onus should be on the auditor to detect material fraud in all reasonable ways. While it is admitted that the primary responsibility of the prevention and detection of material fraud must rest with the directors the management

and the internal audit, there is also an expectation that the auditors should take reasonable action when they suspect the irregularities including fraud should report the work that they performed to conclude whether the director's statement regarding the action taken to prevent and detect material fraud are accurate.”

This beautifully sums up responsibility the Management, Board and Independent Directors and auditors.

Finally for ensuring transparency and good governance, in my view at least three things must be done.

First,

Boards and Directors have to be very careful in appointing statutory auditors. Ensure that they are truly independent and not conflicted. Section 144 of the Companies Act, and Code of Ethics are mandatory and should be followed not only in letters but spirit.

Second,

Empower auditors to ask questions to you. Do not feel offended if he asks inconvenient questions. As I said, he is duty bound to do this. Actively engage with them during the audit. The audit committee role should not be limited only to discussing them in one committee meeting and approving it. It requires a deeper and continuous engagement with the auditor. The Board and the Audit Committee should ask the auditors to give evidence as to how they have done the sampling, how they have verified the chosen transactions, how they have challenged the figures given the CFOs and their teams.

Third,

Use technology, Data Analytics, Machine Learning to identify early warning signals of financial fissures. The phenomenal growth of GST and Income Tax during these difficult years proves the utility of using these Technologies.

These steps will go a very long way in generating Early warning signals, preventing frauds and failures and ensuring good corporate governance. This will also instil trust among the investors and all stakeholders in India's capital market and take our economy to the next level. ■

Thank you.

**Excerpts from the 'Keynote Address' delivered by Dr. Ajay Bhushan Pandey, IAS, Chairperson, National Financial Reporting Authority (NFRA), former Secretary, Ministry of Finance, Govt. of India, at the 'Keynote Session- II' of IOD's Annual Directors' Conclave held on August 10, 2023, in New Delhi.*