1.1 AUDITOR’S INDEPENDENCE: AN INTRODUCTION

In the light of the major corporate scandals in the beginning of this century, the issue of Auditor’s Independence has attracted considerable attention and becomes the focus of much debate. It is well known fact that an audit report is beneficial only if it contains reliable and unbiased information audited by an independent auditor. Once an auditor is perceived to lack independence, the audit work loses credibility and the value of the auditing function is severely impaired. As a result, users will have less confidence in the financial statements. Therefore, the future of the auditing profession is argued to be dependent upon an Auditor’s Independence.

The Auditor’s Independence is the capacity of an auditor to do audit unaffected by external impact. An auditor must stand isolated from the organization (Abdoli, 2012). Auditor have a responsibility towards the public because their existence is to make an assurance that the information released is reliable. For proper audit of financial statements in an unbiased way auditor must be free. Independence is viewed as an imperative trademark for an auditor; it lets people in general realize that they give objective opinion about the financial statements, which is basic purpose of auditing. (Adeyemi & Akinniyi, 2011).

Auditor’s Independence is both an ethical and a professional issue, crucial to auditor. There are three meanings of Auditor’s Independence: First, in the sense of not being subordinate, it means honesty, integrity, objectivity and responsibility. Second, in the narrow sense, in which it is used in connection with auditing and expression of opinions on financial statements. Third, it means avoidance of relationships, which to a reasonable observer would indicate a conflict of interest.

Stakeholders expect the auditor to find and report all irregularities in the financial statements while the management wants the auditor to ignore manipulation in financial statement. Thus, at many times, the auditor needs to face these conflicting interests. The auditor’s role conflict may negatively affect the Auditor’s Independence and the ability to conduct a fair audit. If the auditor tries to be ethical in a situation of conflict, the management may seek to replace the...
auditor. As a result, the auditor may buckle under the management's pressure, resulting in a compromise of Independence.

Discussion on Auditor’s Independence revolves around two forms: “independence in fact” and “independence in appearance”.

Auditor should be independent in the conduct of the audit to apply their mind to the audit without undue impact from the client’s administration. This is what is referred to as independence in fact or actual independence, which has been characterized as the perspective that allows the performance of duty without being influenced by impacts that compromise professional judgment, enabling a person to act with integrity, and exercise objectivity and professional judgment (Dopuch, King & Schwartz, 2003)³

An auditor is expected to avoid situations that might cause others to conclude that he or she is not maintaining an unbiased, objective attitude of mind. This facet of the Auditor’s Independence is defined as perceived independence. Perceived independence has been characterized to mean the avoidance of facts and situations which are significant to the point that a sensible and knowledgeable outsider would scrutinize the auditor’s capacity to act impartially (Beattie, Brandt & Fearnley, 1999)⁴.

1.2 SIGNIFICANCE OF STUDYING AUDITOR’S INDEPENDENCE

Auditor perform a very important function because they are the only independent examiners of financial statements before they are released to public and in their profession “independence” is key component. Independence is critically important to an auditor as it is regarded as being one of the fundamental principles underlying the auditor's work. The stakeholders must have confidence in the integrity and objectivity of auditor. Without definite independence, an audit has little value. Recently researchers, regulators and the public have been concerned about Auditor’s Independence in the current audit environment where severe audit failures like Enron, WorldCom, Satyam, etc. have emerged. Therefore,
Auditor’s Independence has been the focus of almost constant controversy, debate and analysis.

Auditor has vigour to identify wrongdoer in administration and give are part of the organization impartially. Only an independent auditor can assume his duty successfully and help in maintenance of good governance.

A great anxiety is placed on auditor in the point of view of Auditor’s Independence in light of the fact that in a large number of cases, an auditor is supposed to be the principal individual to spot corporate scandal. Therefore, it is expected that auditor must be sufficiently independent to deliver all facts in his report and not hesitant on his part in unveiling the defects, defaults, abnormalities and inconsistencies.

Auditor’s Independence is a globally debated concept with numerous attributes. Auditor is given wide powers to enable him to detect wrongdoings by the administration. In fact, the auditors can assume his role successfully only when he is independent. Auditor’s Independence is fundamental base for an effective and objective audit. Prominently, Auditor’s Independence is a key determinant for investors in deciding whether to put resources into any organization. The best alternate to make auditor independent is to feel more reliable, obedient and honest while confining themselves to their term of engagement. (Brandon, 2013)

Hence, in conducting an audit, auditors is obliged to adopt a substantially stricter strategy to their clients. In this manner, there is a definite need to leave from the myth that auditors are just watchdogs (Bakar & Ahmed, 2009).

1.3 THREATS TO AUDITOR’S INDEPENDENCE

There are numerous threats that undermine Auditor’s Independence. These can be assembled into four classifications of threats namely environment based threats, remuneration based threats, relationship based threats and service based threats (Walabyeki, 2008).
1.3.1 Environment Based Threats

The environment-based threats can be subdivided into four categories. These are audit client’s corporate culture, audit firm’s work culture, reporting standards and auditing frameworks and procedures.
1.3.1.1 Client’s Corporate Culture: It incorporates the moral gauges and professionalism of executives of Client Company. Where the executives have low moral principles, there will be more pressure on the auditor to compromise his integrity over the span of the audit. Thus, where the audit client's administration is portrayed by a high level of inadequacy, it might bring about disability of auditor to be independent, since it will be hard to get to adequate and suitable audit evidence.

1.3.1.2 Audit Firm’s Work Culture: The audit firm’s internal organization and reputation are key elements to be considered in maintenance of Auditor’s Independence. A reputed firm has a superfluous inspiring factor to be independent in order to save its reputation (Ashkanasy & Windsor, 1997). The reason is that compromising the independence would have negative impact on their independence. Additionally, if moral standards of the firm are low, the auditor will be less disposed to oppose audit client’s pressure.

1.3.1.3 Reporting Standard: Vague reporting standards can be a threat for Auditor’s Independence as they make it easier for auditor to give biased audit opinion. The nonappearance of clear reporting standards gives auditor the opportunity to utilize their discretion to encourage manipulated reporting by their audit clients. (John & Chukwameriji, 2012). An unethical auditor can cleverly use the loopholes of reporting standard to hide misleading financial information and report thereon.

1.3.1.4 The Auditing Framework and Procedure: With respect to auditing frameworks and procedure, a risk may emerge where there are some issues requiring judgment. They include circumstances where complex financial transactions are required to be audited, where executives make significant estimates or assumptions, when interpretations of applicable accounting principles is difficult and proper level of materiality is required to be resolved (Strier, 2006).

1.3.2 Relationship Based Threats

An auditor is locked in number of relationship that may give rise to threats as follows:
**Fig 1.3: Relationship Based Threats**

1.3.2.1 *Dual Employment:* The complex relationship between auditor and client develops because of dual employment. It indicates the circumstance where both the audit client and the audit firm employ the auditor. It would bring about conflicting circumstance, as the auditor will be constrained to serve two employers (Wright, A. & Wright, S., 1997)\(^{11}\). In such case the auditor's objectivity will be compromised since to make a report that is contrary to the audit client makes him endanger his employment with the audit client.

1.3.2.2 *Family Relationship:* The second relationship threat can be family connections between the auditor and the representatives of the audit client. The family holdings are probable to obstruct the auditors from making objective decisions, on the grounds that the affiliations and family relationship will summon auditor to defend companions or relatives (Bamber & Iyer, 2007)\(^{12}\). In such conditions, the auditor will be confronted with the difficult decision of yielding these connections or satisfying his or her statutory commitments.

1.3.2.3 *Long Auditor-Client Relationship:* Third, is the relationship due to prolonged engagement of the auditor by a same audit client. As the relationship proceeds, there is familiarity, lack of innovation, less rigorous audit procedures and undue confidence in the audit client (Carcello & Nagy, 2004)\(^{13}\). With prolonged audit tenure, the auditor gets too much familiar with the client and their financial statements that he becomes reluctant in doing thorough audit. This tendency of an auditor leads to unveiled or undiscovered material misstatement.

1.3.2.4 *Former Employee of Audit Client Appointed as Auditor:* Fourthly, is a relationship whereby the previous employee of the audit client is hired by the audit firm. The auditor’s previous affiliations to the audit client may become barrier in
the auditor's objectivity (Teoh & Lim, 1996). The threat may arise as the knowledge of previous employment may obstruct “independence in fact”. Therefore, in such case auditor would not be able to carry on profession as an independent outsider.

1.3.2.5 Gift from Audit Client: When an auditor gets gifts and hospitality from the audit client, it may create threat because of casual relationship. The special treatment makes a bond between the auditor and the audit client, which may adversely influence the auditor’s objectivity and independence (Pany & Reckers, 1980). The undue hostile treatment makes the auditor to adopt a liberal attitude towards fallacies in financial statements.

1.3.2.6 Intimidation by Audit Client: During the audit engagement there may occur a situation where an oppressive authority of the audit client utilizes his or her position to threaten the auditor. Thus, where the auditor is faltering he or she will not give an unprejudiced report attributable to his or her incapacity to oppose the audit client's pressure (Teoh, 1992). Because of such threat auditor tend to compromise his independence because of fear of losing audit client.

1.3.3 Remuneration Based Threats

1.3.3.1 Inadequate Funds: Remuneration based threats include inadequate fee which constrains the auditor to do a thorough audit. Such audit will be unsatisfactory because of the absence of funds for a more comprehensive audit. The constrained measure of compensation influences the auditor’s capacity to access audit evidence (Okaro & Okafor, 2013). In such case, audit program will not be based on what will bring about a successful audit; however what will fit inside the constrained fee.
1.3.3.2 **Fear of Losing Source of Earning:** A further threat is the likelihood that the auditor's compensation will be ceased by termination of the audit engagement. End of engagement is a threat to independence, since it will bring about the loss of income. This is particularly so where the compensation frames a generous portion of the audit firm’s revenue, or where the audit firm has a limited audit client profile (Adeyemi & Olowookere, 2012). In this way auditor will be inclined to give a report in favor of the audit client because of monetary reliance on his client. This reliance gives audit client an opportunity to influence the ultimate result of the audit.

1.3.4 **Service Based Threats**

Service based threats emerge in two conditions in particular as follows.

1.3.4.1 **Self Review Threat:** It arises where an audit firm or an individual auditor is set in a position of reviewing subject matter which the firm or individual were previously responsible for. This would be the situation where an individual from the audit team having been a director or officer of the audit client, is in a position to fundamentally influence the subject matter of audit of the same client (ICAI, 2009). It also emerges where the auditor carries out non-audit service that directly affect the subject matter of the current or a subsequent audit engagement.

1.3.4.2 **Advocacy Threat:** With respect to advocacy services, threat may arise when the audit firm or individual from the audit team, promotes or may be perceived to promote the audit client’s position to the point that his/her objectivity may be compromised. The auditor’s association with the audit client as advocate clashes with the auditor’s obligation to be an impartial outsider in the undertakings of the organization (Haynes, Jenkins & Nutt, 1998). Illustrations include managing in or being a promoter of shares or different securities of an audit client, and working as an advocate on behalf of an audit client in prosecution or in settling disputes with outsiders.
1.4 SAFEGUARD TO AUDITOR’S INDEPENDENCE

There are various safeguards which can be utilized as safeguards against threats to Auditor’s Independence. These can be categorized into three major groups: audit engagement controls, internal governance measures, and oversee of the audit function.

![Fig 1.5: Safeguard to Auditor’s Independence](image)

1.4.1 Audit Engagement Controls

Audit engagement controls are subdivided into five controls in particular auditor appointment and removal control, auditor-client relationship control, audit fee control, audit service control and audit process control.

![Fig 1.6: Audit Engagement Controls](image)
1.4.1.1 Auditor Appointment and Removal Control: Such controls are equipped towards constraining the powers of appointment and removal of an auditor by the board of directors. This restriction can be accomplished by either conferring powers of appointment or removal to the shareholders, audit committee or a regulatory body. Such control can also be achieved by imposing mandatory auditor retention

- Conferring Power to Shareholders

  The shareholder’s power of appointment of the auditors can be practiced through the general meeting. The directors may just be vested with powers of appointment and remuneration of auditors in exceptional circumstances; for example, first the auditor of the company or to fill a casual vacancy. Right of removal can also be transferred to shareholders to guarantee that the removal of auditors remains protected from the impact of the management (Suyono, 2012)\(^\text{21}\). Additionally, the auditors may be given a right to be heard for their removal. This can be done by giving them a privilege to attend the meeting at which the resolution for their removal is to be passed. The reason is to give the auditor a chance to expose if his or her removal is mala fide.

- Conferring Power to Audit Committee

  The audit committee may be engaged to appoint and remove auditor directly. As a measure to protect the appointment procedure of the auditor from the management of the organization, non-executive directors can be appointed in the audit committee (Gendron & Bedard, 2006)\(^\text{22}\). This measure may however not be influential particularly when the non-executive directors are not independent from the management of the organization.

- Conferring Power to Regulatory Body

  The powers of appointment and removal of auditors could also be vested with a regulatory body. The benefit of endowing an independent body with this control is that unlike appointment by shareholders, and audit committee, the auditors are free from the likelihood of direct or indirect control by the management of the organization (Bu-Peow Ng & Tan, 2003)\(^\text{23}\). The auditor can
consequently make audit reports without fear or favor. However, this measure can encroach on the privileges of the shareholders to select the auditor of their choice.

- **Mandatory Auditor Retention**

  This control is not concerned with appointed of the auditor, instead it is considered after the appointment of auditor. It is confined to the power of removal of the auditor. Compulsory auditor retention requires the audit client to hold an auditor for not less than a predetermined number of years (Dopuch, King & Schwartz, 2003). In this manner, the auditor cannot be removed before the expiry of that time. The reason for this safeguard is that the auditor will not confront any dismissal threat within the predetermined period. The drawback is that audit quality might be unfavorably influenced because of the guaranteed tenure of engagement.

1.4.1.2 **Auditor- Client Relationship Controls:** The objective of this classification of controls is to isolate the relationship bond that hinders Auditor’s Independence. This control incorporates mandatory audit firm rotation, mandatory rotation of audit partners, cooling off period, and disclosure/prohibition of conflict of interest situations.

- **Mandatory Audit Firm Rotation**

  Mandatory audit firm rotation is a safeguard against the relationship-based threat that emerges because of a prolonged tenure of tenure with same client. It requires the audit client to replace the audit firm after a particular period as required by law. Subsequently, the independence undermining relationship is discontinued. The new firm of auditor assumes control over the audit and carries it with fresh alertness, diligence and perspective (Ebimobowei, 2011). However, it might bring about a decrease in audit quality because the new audit firm have little information of the client’s financial framework and it may take some time get acquaint with it.

- **Mandatory Audit Partner Rotation**

  This safeguard sets a limit on the period for which key auditor of audit firm may continue to take part in particular audit engagements. Unlike the audit firm rotation, this concentrates on individual auditors inside the audit firm, and not the
whole audit firm. The argument behind is to strike a harmony between the need of fresh look on the engagement, and a requirement of audit to be done by experienced auditor (Mgbame, Eraghe & Osazuwa, 2012)\textsuperscript{26}. This safeguard although might be disadvantageous to smaller audit firms. The reason is that most small firms do not have many audit partners and it would be the same as mandatory audit firm rotation for them.

\begin{itemize}
  \item \textbf{Cooling Off Period}
  
  The cooling off period is a period that must lapse before audit client can employ previous employees or the owners of the audit firm. It’s purpose is to demoralize auditor from doing biased audit with the expectation to be employed by the audit client in future. Further, it makes a more prominent appearance of independence among the people in general. The cooling off period however restrains an organization's flexibility to appoint whoever is best for a specific position.

  \item \textbf{Prohibition/Disclosure of Conflict of Interest Situations}
  
  Legislation often prohibits individuals with specific associations with the company from being auditor. The presumption is that these connections influence both actual and perceived independence of the auditor. Therefore, this measure restricts the appointment of a person who advantageously possesses or controls, directly or indirectly, a material interest in affairs of audit client. To supplement the restrictions, there may be a necessity for declaration of such circumstances or connections to a regulatory body and allowing interested individuals to seek for court intermediation where there is a breach.

\end{itemize}

1.4.1.3 \textit{Audit Fee Control}: This safeguard protects Auditor’s Independence from threats that emerge because of issues that are related to fee.

\begin{itemize}
  \item \textbf{Conferring Power to Shareholders}
  
  To guarantee that the management of the company does not affect the fee of the auditor the powers of remuneration of the auditor may explicitly be conferred to shareholders of the company. If the management of the audit client has an immediate impact over the auditor’s remuneration, they could easily affect the
result of the audit (Mayhew & Pike, 2001). They could do this by deteriorating the remuneration of auditor if he issue a report that is incompatible to his interests. The auditor would therefore be compelled to compromise his/her independence.

- **Conferring Power to Audit Committee**

  The powers of remuneration may be conferred to the audit committee. In such manner, the committee can guarantee that auditor get adequate compensation, so that a comprehensive audit can be completed. It can also be contributory in surveying whether the compensation received by the auditor can possibly make a financial dependence on a specific audit client (Abbott, Parker, Peters & Raghunandan, 2003).

- **Limiting Fee from Single Client**

  Audit fee controls may also include confining the incomes that can be collected from a single audit client. The objective of this measure is to prevent an undue monetary reliance on one specific audit client. This may emerge particularly where the aggregate income of the auditor from single audit client is very large, in respect to that acquired from other audit clients. Because of fear of losing this emolument, the auditor might be skewed to make reports that support the audit client's administration (Craswell, Stokes and Laughton, 2002).

**1.4.1.4 Audit Service Control:** Audit service controls address the issues that emerge from the provision of non-audit service and advocacy service.

- **Prohibition of Non-Audit Service**

  Prohibition on an auditor from providing non-audit service along with audit service can be an effective safeguard for protection of Auditor’s Independence. The rationale is that the auditor can concentrate on core audit and will not compromise independence in greed of lucrative non-audit service fee. Nevertheless, it can negatively influence audit quality, as there are certain services that are the best given by the company’s auditor. This is because the company’s auditor knows the organization’s issues best, and will hence be in the best position to comprehend completely the complications of a transaction concerning the organization’s activities (Javidi, 2013).
Prohibition on Advocacy Services

Concerning, Advocacy Services, prohibition on such services can enhance appearance of independence in general. Reducing business ties between auditor and client boost stakeholder’s confidence in audit. Through prohibition on litigation service, the success of failure of client’s litigation would not influence auditor’s attest function in any respect.

1.4.1.5 Audit Process Control

Free Access to Audit Evidence

To symbolize a careful and extensive audit, the auditor must have unhindered access to all the reports and records. Audit process controls are aimed for guaranteeing that auditors have boundless approach to audit evidence (Fearnley, Hines, McBride & Brandt 2002)\textsuperscript{31}. The independence to get to audit evidence could be accomplished in three striking ways. Firstly, organizations might be required by law to give the auditor boundless access to the financial record of organization. Hence, the articles of association of an organization that limit the auditor's access in such manner are void. Secondly, law may provide that auditors should be entitled to acquire from the officers of the organization such data and clarification, as they believe is vital for the execution of the obligations. Finally, as legislative action may be enforced on the organization's authorities, who refuse to provide evidence or clarifications as required by auditor.

Independence to report

Through legislation it can be provided that the auditor should make a report to the organization's members directly face to face in a meeting specially conducted for this purpose. Therefore, the executives of the organization will not find any opportunity to solve a contradiction over a financial matter and thereby pressurizing auditors to express the report in an ambiguous way. The auditor must be free from control or undue impact in expression of recommendations or opinions (La Porta, Lopez-de-Silanes, Shleifer & Vishny, 2000)\textsuperscript{32}. Additionally, it can also be provided that the auditor presents its report or any disagreement/contravention directly to the audit committee.
1.4.2 Internal Governance Measures

Internal governance measures are safeguards that can be executed inside the audit client’s company and the audit firm.

![Fig 1.7: Internal Governance Measures](image)

1.4.2.1 Internal Audit Client Measures: These measures are for guaranteeing high level of professionalism inside the audit client company which makes a sphere helpful for Auditor’s Independence. A further four measures are.

- **Internal Control**

  The principal measure is that of keeping up a sound internal control. The internal control incorporates the approaches and procedures, which guarantees that there is a high standard of internal and external reporting. It requires proper maintenance of records and procedures that create the stream of timely and reliable information, from inside and outside the organization. The proper maintenance of records is vital in the light of the fact that it guarantees that there is sufficient audit evidence that auditors can use, to frame an independent opinion of the financial condition of the company (Hay, Knechel & Ling, 2008)\(^\text{33}\).

- **Internal Audit**

  Internal audit gives assurance to the management that the risk management, internal control and governance processes are adequate. The scope of internal audit also includes commitment to integrity and accountability, effectiveness of operations, reliability of financial and management reporting. Thus, an effective internal audit can also be safeguard to protect independence of external auditor.
Audit Committee

The audit committee serves several functions in guaranteeing that the internal governance of audit client is favorable for an independent audit. It monitors and assesses the adequacy of the company’s internal control and audit. Where there are shortcomings in the internal control and the internal audit, the audit committee can bring up out so that the inadequacies are corrected (Zhang, Zhou, J. & Zhou, N. 2007)\textsuperscript{34}. Further, the audit committee provides a platform for auditor to convey any grievances, particularly when the administration put pressure on the auditor to compromise his or her independence.

Ethical Standard of Audit Client

High ethical guidelines inside the audit client can moderate the pressure on the auditor to compromise his or her independence. The organization may codify its own moral standards that can be used as a measuring stick to recognize dreadful moral conduct (Ashkanasy & Windsor, 1997)\textsuperscript{35}. Such measure can prevent inclinations that could make an environment that is unfavorable for auditor’s independence. The audit client should also make internal frameworks and strategies to guarantee that the compliance with the code of conduct is observed and controlled.

1.4.2.2 Internal Audit Firm Governance Measures: Internal audit firm measures might be classified into two groups namely, firm-wide measures and engagement specific measures.

Firm-wide Measures

The most essential firm wide safeguards can be development and execution of policies which are equipped particularly towards guarding impairment of Auditor’s Independence. These policies should highlight the threats to independence and control that can be adapted towards prevention of loss of independence. The application and monitoring could be accomplished through conducting consistent internal workshops. Having such workshops could guarantee that the auditor is always on the caution to ensure that their independence is not compromised.
Engagement Specific Measures

Such measures cover independence related issues that emerge concerning a particular audit client. Measures in this regard incorporate discussing about independence issues with the audit committee or others in charge of governance. In addition this measure may also incorporate expelling a person from the engagement when there is a conflict of interest relationship or situation.

1.4.3 Oversee of Auditor’s Role

Oversee of auditors could either occur indirectly through oversee of the profession or as the oversee of the individual auditor.

Fig 1.8: Oversee of Auditor’s Role

1.4.3.1 Oversee of the Profession: A number of oversee functions that could be exercised are by regulatory authority are:

- **Standard Setting**
  
  Oversee of the profession incorporates the setting of uniform principles for accounting and auditing. Standards frame the parameters inside which directors are required to do their financial reporting and determine how the auditor is to verify the financial information (Baydoun, Maguire, Ryan & Willett, 2013)\textsuperscript{36}. Without clear auditing principles, auditor can use their discretion, to support manipulated reporting by their clients. Where clear and uniform benchmarks are set, auditor have less space to utilize his/her suspicion to encourage biased auditing.

- **Establishing Code of Conduct**
  
  Another role that can be played by regulatory authority to strengthen the competence and ethics is framing of code of conduct to guide the profession. High-level ethical behavior of an auditor is established by setting professional code of
conduct (Spira and Page, 2005). Effective implementation of such code of conduct can be achieved by imposing it compulsorily on the auditor working in the jurisdiction.

- **Disciplinary Actions**

  The disciplinary actions against auditor who disregard the ethical standards and codes of conduct can be a strong safeguard to protect Auditor’s Independence. Disciplinary actions are critical in light of the fact that they serve as a tool to prevent auditor from compromising their independence (Davis & Simon, 1992). The adequacy of disciplinary actions as a prevention can be enhanced by public hearings and disclosure of decisions against offending auditor.

1.4.3.2 *Oversee of Individual Auditor*: The audit committee, audit firm, and a regulatory body can practice oversee of the individual auditor.

- **Oversee through Audit Committee**

  The audit committee assumes an essential role in the appointment procedure of the auditor. In practicing oversee, it may ensure that the correct procedure for appointment and removal is followed. In this manner, the committee guarantees that the management of the audit client does not unduly affect the appointment and removal procedure. Similarly, when the auditor leaves, the audit committee may explore the issues relating to the auditor’s resignation. This measure would result in preventing opinion shopping and removal of capable and independent auditor by the audit client’s administration. Oversee by the audit committee also includes the constant appraisal of the auditor’s commitment to maintaining independence (Aguilera & Cuervo-Cazurra, 2009).

- **Oversee by Audit Firm**

  The key partners of the firm may accomplish the oversee of auditors in the audit firm internally. Being in senior positions in the firm the partners can appropriately regulate the adherence to internal quality control measures by their subordinates. Consequently, where there is clash with the internal strategies of auditors independence the partners can take disciplinary measures against the offending auditors. It can also be effective by having peer evaluation of fellow
audit partners inside the audit firm. Externally, another firm may also practice oversee function. It may include performing or re-performing some portion of the audit by another audit firm. Oversee by another firm keeps the audit firm alert, as it assures that the outside firm not to identify imperfections in its audit frameworks and procedures (Al-Ajmi, 2009).

➢ **Oversee by Regulatory Body**

An investigation by the outside regulatory body is significant for the auditing profession. Investigation is critical in light of the fact that it ensures that measures that are applicable to independence are adhered to. The regulators can adopt policy of releasing consequences of the investigation publically. Positive findings can upgrade auditor’s profile as competent professional whereas negative findings adversely affect the audit firm’s reputation. Unfavorable findings may also frame the premise of disciplinary activity by the regulatory body.

### 1.5 GUIDANCE NOTE ON AUDITOR’S INDEPENDENCE

In a guidance note issued by ICAI, following threats and safeguards to Auditor’s Independence have been discussed:

#### 1.5.1 Threats to Independence

Five types of threats have been mentioned in Guidance Note on Auditor’s Independence. These are as follows:

- (i) **Self-interest threats** - Such type of threat occur because of financial interest of an auditing firm, its partner or associate in an audit client.

- (ii) **Self-review threats** – Such occur during a review of any judgement or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client.

- (iii) **Advocacy threats**: Such threats 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

- (iv) **Familiarity threats**: When auditors form familiar relationships with the
client and became sympathetic to the client's interests, there occurs familiarity threat to Auditor’s Independence.

(v) Intimidation threats: In situations where auditors are deterred from acting objectively with an adequate degree of professional skepticism there is occurrence of Intimidation threats

1.5.2 Safeguards to Independence

To address the issue of Auditor’s Independence, ICAI mentioned following guiding principles in the guidance note:

- For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing.

- In the case of audit, the key fundamental principles are integrity, objectivity and professional skepticism, which necessarily require the auditor to be independent.

- Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.

- When such threats exist, the auditor should either desist from the task or, at the very least, put in place safeguards that eliminate them. All such safeguards measure needs to be recorded in a form that can serve as evidence of compliance with due process.

- If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

1.6 INDIAN LEGISLATIONS FOR PROTECTION OF AUDITOR’S INDEPENDENCE

The issues surrounding threats to Auditor’s Independence and safeguards are alarming signals that there is immediate requirement to have some laws in this regard. A number of reporting guidelines, laws and standards have been developed to serves framework for auditing profession. There are various guiding principles
at national as well as international level for Auditor’s Independence. A detailed discussion of some major guidelines at national level are:

1.6.1 Companies Act, 1956

In order to ensure independence, the law has made certain provisions which prohibit the appointment of a person as auditor in certain circumstances. The appointment of a Chartered Accountant as auditor of a Company is prohibited if he is:

(i) an officer or employee of the Company;
(ii) a partner of a person in the employment of an officer or of an employee of the Company;
(iii) a person who is indebted to the company for an amount exceeding Rs. 1000;
(iv) a person who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding Rs. 1000;
(v) a person holding any security of that company.

A person who is disqualified from becoming auditor of anybody corporate under the above rules is also disqualified from appointment as auditor of such body's subsidiary, co- subsidiary or holding company. (Companies Act, 1956)

1.6.2 Companies Bill 2009

❖ Rotation of Auditor

Clause 123 (1A) of bill provides for compulsory rotation of the auditors. Under this an individual auditor who has completed a consecutive tenure of five years shall not be eligible for re-appointment as auditor in the same company for three years from the completion of such tenure of five consecutive years whereas an audit firm which has completed a consecutive tenure of five years shall not be eligible for re-appointment as auditor in the same company for five years from the completion of such tenure of five consecutive years.

It is further provided that where a firm is appointed as an auditor of a company, the auditing partner of the firm shall be rotated by the audit firm on
completion of three consecutive years and such auditing partner shall not be eligible to be re-appointed as auditing partner of the same company till the expiry of three years from the date of completion of his three year tenure.” (Companies Bill 2009)\(^42\)

- **Panel of Auditor**

  In the Companies bill 2009, it is provided that the appointment of auditor should be made by the Registrar of Companies from the panel of Chartered Accountants. The Committee recommends that the advisory body, namely National Advisory Committee for Auditing and Accounting Standards (NACAAS) may be trusted to develop and prepare a comprehensive list of audit firms over a period of three years, after which it will be mandatory for any company to appoint an auditor from this list. (Companies Bill 2009)\(^43\)

- **Prohibition of Non-Audit Services**

  In order to ensure that auditor’s independence is not compromised because of fee earned by him from non-audit service, the bill prohibits auditor to render following services:

  (a) Accounting and book keeping services;
  
  (b) Internal audit;
  
  (c) Design and implementation of any financial information system;
  
  (d) Actuarial services;
  
  (e) Investment advisory services;
  
  (f) Investment banking services;
  
  (g) Rendering of outsourced financial services; and
  
  (h) Management services.” (Companies Bill 2009)\(^44\)

- **Suggestions on Clause 127**

  On above clause of prohibition on non-audit service various suggestions received from various institutions/experts are given below-

  (i) Service in (a) & (c) of clause 127 are suggested to be amended and read as
(a) Accounting, cost accounting and book keeping services.

(b) Design and implementation of any financial and cost information system.

(ii) For due diligence and unbiased application of mind of the auditors without succumbing to external influences, it is suggested that negative item list of Clause 127 of the Bill should be extended to the subsidiary companies also.

(iii) It is also advised that subsidiaries over a certain size to have different auditors, then the parent company (Companies Bill 2009).45

➢ **Contravention of provision**

i) As per Companies Bill 2009, on contravention of any provision stated above, the company shall be punishable with fine which may extend from twenty-five thousand rupees to five lakh rupees and any officer who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which may extend from ten thousand rupees to one lakh rupees, or with both.

ii) An auditor of a company contravening the provision shall be punishable with imprisonment for a term which may extend to one year and with fine which may extent from fifty thousand rupees to twenty-five lakh rupees. Such auditor is requires to

a) Refund the remuneration received by him to the company; and

b) Pay for damages to the company or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report. (Companies Bill 2009)46

1.6.3 Corporate Governance Voluntary Guidelines 2009

➢ **Appointment of Auditors**

For ensuring independence of auditor, the corporate governance voluntary guidelines 2009 provides that appointment of auditor should be done on following guidelines:
a) The Audit Committee of the Board should be the first point of reference regarding the appointment of auditors.

b) The Audit Committee should have regard to the profile of the audit firm, qualifications and experience of audit partners, strengths and weaknesses, if any, of the audit firm and other related aspects.

c) The Audit Committee should:

- discuss the annual work programme and the depth and detailing of the audit plan to be undertaken by the auditor, with the auditor;
- examine and review the documentation and the certificate for proof of independence of the audit firm, and
- recommend to the Board, with reasons, either the appointment/re-appointment or removal of the statutory auditor, along with the annual audit remuneration. (Corporate Governance voluntary guidelines 2009)⁴⁷

➢ Certificate of Independence

In the guidelines, it is provided that every company should obtain a certificate from the auditor certifying his/its independence and arm's length relationship with the client company. Such certificate of Independence should certify that the auditor together with its consulting and specialized services affiliates, subsidiaries and associated companies or network or group entities has not/have not undertaken any prohibited non-audit assignments for the company and are independent vis-à-vis the client company. (Corporate Governance voluntary guidelines 2009)⁴⁸

➢ Rotation of Audit Partners and Firms

For maintaining independence of auditors a policy of rotation of auditors provided as below:

- Audit partner - to be rotated once every three years
- Audit firm - to be rotated once every five years.
Further, a cooling off period of three years should be elapsed before a partner can resume the same audit assignment. This period should be five years for the firm to resume its position. (Corporate Governance voluntary guidelines 2009)\textsuperscript{49}

1.6.4 Report of Confederation of Indian Industry (CII) Task Force on Corporate Governance

- **Revenue from Single Client**
  
  The report provided that to ensure objectivity of an auditor, not more than 10% of the revenues of an audit firm singly or taken together with its subsidiaries, associates or affiliated entities should come from a single corporate client or group with whom there is also an audit engagement.” (CII Task Force)\textsuperscript{50}

- **Certificate of Independence**
  
  The report provides that every company must obtain a certificate from the auditor certifying the firm’s independence and arm’s length relationship with the client company. The Certificate of Independence should certify that the firm, together with its consulting and specialized services affiliates, subsidiaries and associated companies or network or group entities have not / has not undertaken any prohibited non-audit assignments for the company and are independent vis-à-vis the client company, by reason of revenues earned and the independence test are observed. (CII Task Force)\textsuperscript{51}

- **Audit Partner Rotation**
  
  The report provide that the partners and at least 50% of the audit engagement team responsible for the audit should be rotated every six years. A cooling off period of 3 years should elapse for a partner to resume the same audit assignment. (CII Task Force)\textsuperscript{52}

1.6.5 Naresh Chandra Committee

- **Disqualifications for Audit Assignments**
  
  The Committee recommends an abbreviated list of disqualifications for auditing assignments, which includes:
a) Prohibition of any direct financial interest in the audit client by the audit firm, its partners or members of the engagement team as well as their ‘direct relatives’. This prohibition would also apply if any ‘relative’ of the partners of the audit firm or member of the engagement team has an interest of more than 2 per cent of the share of profit or equity capital of the audit client.

b) Prohibition of receiving any loans and/or guarantees from or on behalf of the audit client by the audit firm, its partners or any member of the engagement team and their ‘direct relatives’.

c) Prohibition of any business relationship with the audit client by the auditing firm, its partners or any member of the engagement team and their ‘direct relatives’.

d) Prohibition of personal relationships, which would exclude any partner of the audit firm or member of the engagement team being a ‘relative’ of any of key officers of the client company, i.e. any whole-time director, CEO, CFO, Company Secretary, senior manager belonging to the top two managerial levels of the company, and the officer who is in default.

e) Prohibition of service or cooling off period, under which any partner or member of the engagement team of an audit firm which wants to join an audit client, or any key officer of the client company wanting to join the audit firm, would only be allowed to do so after two years from the time they were involved in the preparation of accounts and audit of that client.

f) Prohibition of undue dependence on an audit client so that no audit firm is unduly dependent on an audit client. The fees received from any one client and its subsidiaries and affiliates, all together, should not exceed 25 per cent of the total revenues of the audit firm. However, to help newer and smaller audit firms, this requirement will not be applicable to audit firms for the first five years from the date of commencement of their activities, and for those whose total revenues are less than Rs.15 lakhs per year.” (Naresh Chandra Committee)
List of Prohibited Non-Audit Services

The Committee recommends that the following services should not be provided by an audit firm to its audit client:

a) Accounting and bookkeeping services, related to the accounting records or financial statements of the audit client.

b) Internal audit services.

c) Financial information systems design and implementation, including services related to IT systems for preparing financial or management accounts and information flows of a company.

d) Actuarial services.

e) Broker, dealer, investment adviser or investment banking services.

f) Outsourced financial services.

g) Management functions, including the provision of temporary staff to audit clients.

h) Any form of staff recruitment, and particularly hiring of senior management staff for the audit client.

i) Valuation services and fairness opinion.

Further in case the firm undertakes any service other than audit, or the prohibited services listed above, it should be done only with the approval of the audit committee. (Naresh Chandra Committee)

Independence Standards for Consulting and Other Entities that are Affiliated to Audit Firms

a) For an audit firm having subsidiary, associate or affiliated entities, yardstick of not more than 25 per cent of revenues coming from a single audit client stated in recommendation 2.1 should include consolidated entity also. Thus, not more than 25 per cent of the revenues of the consolidated entity should come from a single corporate client with whom there is also an audit engagement.
b) The prohibitions listed in recommendation 2.1 apply in full to all affiliated consulting and specialized service entities of any audit firm that are either subsidiaries of the audit firm, or have common ownership of over 50 per cent with the audit firm. (Naresh Chandra Committee)  

➢ Compulsory Audit Partner Rotation

The recommendations of Naresh Chandra Committee doesn’t favour of compulsory rotation of audit firms. However, it recommends that:

a) The partners and at least 50 per cent of the engagement team (excluding article clerks and trainees) responsible for the audit of either a listed company, or companies whose paid up capital and free reserves exceeds Rs.10 crore, or companies whose turnover exceeds Rs.50 crore, should be rotated every five years.

b) In accordance with the provisions of the European Union and the International Federation of Accountants (IFAC) persons who are compulsorily rotated could be allowed to resume same position only after a break of three years.” (Naresh Chandra Committee)  

➢ Auditor’s Annual Certification of Independence

The committee recommends that audit firm must submit a certificate of independence to the audit committee or to the board of directors of the client company certifying that the firm, together with its consulting and specialized services affiliates, subsidiaries and associated companies:

- independent and have arm’s length relationship with the client company;
- are not engaged in any non-audit services listed and prohibited in recommendation 2.2 ; and
- are not disqualified from audit assignments by virtue of breaching any of the limits, restrictions and prohibitions listed in recommendations 2.1 and 2.3. (Naresh Chandra Committee)
Setting up of Independent Quality Review Board

a) The committee recommends that three independent Quality Review Boards (QRB) should be established, one each for the ICAI, ICSI and ICWAI to periodically examine and review the quality of audit, secretarial and cost accounting firms, and pass judgment and comments on the quality and sufficiency of systems, infrastructure and practices.

b) It is also recommended that for the initial five years the QRBs should focus on audit firms which have conducted the audit for the top 150 listed companies ranked according to market capitalization. (Naresh Chandra Committee)\(^58\)

Proposed disciplinary mechanism for auditors

a) The committee recommends merging of two different schedules offences and misconduct. Further, the committee also recommends to categorize offences according to the severity of misconduct, so that processes can be designed, and punishments awarded, according to the severity of the offence.

b) Prosecution Directorate: The committee recommends formation of an independent permanent directorate within the structure of ICAI, which shall act as the Prosecution Directorate.

c) Disciplinary Committee: The committee recommends formation of disciplinary committee to deal with enquiries in relation to misconduct of members.

d) Publication of decisions of the Disciplinary Committee: The committee also recommends that publicity shall be given by the Prosecution Directorate about the punishment ultimately awarded, through periodicals, newsletters, website and any other means considered appropriate. (Naresh Chandra Committee)\(^59\)
1.6.6 Companies Act 2013

➢ Disqualifications from Being Company Auditor

The Companies Act 2013 provides certain disqualifications to ensure the independence of auditor and for avoiding conflict of interest. As per the Act, following entities or persons have been disqualified from being appointed as an auditor of a company:

(a) a body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008;

(b) an officer or employee of the company

(c) a person who is a partner, or who is in the employment, of an officer or employee of the company;

(d) a person who, or his relative or partner –
   
   i. is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company. However the relative may hold security or interest in the company of face value not exceeding one thousand rupees or such sum as may be prescribed;

   ii. is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary or such holding company, in excess of such amount as may be prescribed; or

   iii. has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, for such amount as may be prescribed;

(e) a person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company of such nature as may be prescribed;
(f) a person whose relative is a director or is in the employment of the company as a director or key managerial personnel;

(g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the that of such appointment or reappointment holding appointment as auditor of more than twenty companies;

(h) a person who has been convicted by a court of an offence involving fraud and a period of ten year has not elapsed from the date of such conviction;

(i) any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialised services as provided in the section. (Companies Act 2013)⁶⁰

➢ Rotation of Auditor

The new Act provides for compulsory rotation of auditor for listed company and company belonging certain class or classes of companies. The companies that are compulsorily required to rotate their auditor includes all unlisted public companies having paid up of rupee ten crore or more. Companies having public borrowing from financial institutions, banks or public deposits of rupees fifty crores or more are also covered even if their paid up capital be lower than the threshold prescribed.

A listed company or class of company prescribed shall not appoint-

(a) An individual as auditor for more than one term of five consecutive years; and

(b) An audit firm as auditor for more than two terms of five consecutive years:

The act also provides that an individual auditor or audit firm that has completed prescribed term under clause (a) and (b) shall not be eligible for re-appointment as auditor in the same company for five years from the completion of his term. Every company, existing on or before the commencement of this Act is required to comply with requirements of rotation within three years from the date of commencement of this Act.
Provided further that as on the date of appointment no audit firm having a common partner or partners to the other audit firm, whose tenure has expired in a company immediately preceding the financial year, shall be appointed as auditor of the same company for a period of five years. (Companies Act 2013)\(^6\)

**Prohibition on Non–Audit Services**

In order to safeguard the independence of auditor because of fee earned from provision of non-audit service along with the audit service. The act prohibits auditor to render certain prescribed services directly or indirectly to company or its holding company or subsidiary company. The specified services are:

(a) Accounting and book keeping services;
(b) Internal audit;
(c) Design and implementation of any financial information system;
(d) Actuarial services;
(e) Investment advisory services;
(f) Investment banking services;
(g) Rendering of outsourced financial services;
(h) Management services; and
(i) Any other kind of services as may be prescribed.

The act provides that an auditor or audit firm who or which has been performing any non-audit services on or before the commencement of this Act shall comply with above provisions before the closure of the first financial year after the date of such commencement. (Companies Act 2013)\(^2\)

**Punishment for Contravention.**

1) The company contravening any of above provision shall be punishable with fine which may extend from twenty five thousand rupees to five lakh rupees and every officer of the company in default shall be punishable with imprisonment for which may extend to one year or with fine which may extend from ten thousand rupees to one lakh rupees, or with both.
2) An auditor of a company contravening any of the above provisions shall be punishable with fine which may extend from twenty-five thousand rupees to five lakh rupees. The Act also provides that if an auditor contravening provisions knowingly or wilfully shall be punishable with imprisonment for a term which may extend to one year and with fine which shall extend from one lakh rupees to twenty-five lakh rupees. Such auditor is required to refund the remuneration received by him to the company and pay for damages to the company, statutory bodies or authorities or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report (Companies Act 2013).

1.6.7 SA 220-Standard on Quality Control of Audit of Financial Statement

- Independence Requirement

The independence requirement of the standard states that engagement partner shall comply with independence requirements that apply to the audit engagement. For such compliance, the engagement partner shall:

(a) Obtain relevant information from the firm and, where applicable, network firms, to identify and evaluate circumstances and relationships that create threats to independence;

(b) Evaluate information on identified breaches, if any, of the firm’s independence policies and procedures to determine whether they create a threat to independence for the audit engagement; and

(c) Take appropriate action to eliminate such threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the audit engagement, where withdrawal is permitted by law or regulation. The engagement partner shall promptly report to the firm any inability to resolve the matter for appropriate action. (SA 220).
1.6.8 SA 200 Overall Objectives of an Independent Auditor and Conduct of an Audit in Accordance with Standard on Auditing

- **Ethical Requirements relating to an audit of financial statements**
  
  This SA states that every auditor is subject to ethical behavior as described in Code of Ethics issued by ICAI. As per Code of Ethics, an auditor is subject to following ethical requirements while discharging his duties as an independent Auditor.

  (a) **Integrity** - Honest behavior, loyal attitude towards users of financial statements;

  (b) **Objectivity** - Independence of mind and independence is appearance of an auditor.

  (c) **Professional competence and due care** - Acquainting with the latest developments in the field of accounting and auditing.

  (d) **Confidentiality** - Not disclosing any information received from client unless it is not legal or professional requirement to do so.

  (e) **Professional behavior** - Professional relation between auditor and client. (SA 200)\(^65\)

- **Requirement to have an attitude of Professional Skepticism**
  
  SA 200 requires an auditor to maintain an attitude of Professional Skepticism which is auditor’s alertness and vigilant approach towards information provided to him from the auditee (SA 200).\(^70\)

- **Requirement to exercise Professional Judgment**
  
  According to SA 200, Professional judgment means judgment taken by the auditor out of his professional experience in an audit situation. The auditor is required to do so because interpretation of relevant ethical requirements and standards throughout the audit cannot be made without the application of relevant knowledge and experience to the facts and circumstances. (SA 200).\(^66\)
1.6.9 SQC 1-Standard on Quality Control

Quality Control for Firms That Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Services Engagements

- The SQC 1 outlines ethical requirements relating to audits and reviews of historical financial information, and other assurance and related services engagements are contained in the Code. These requirements include:

  (a) Integrity;
  (b) Objectivity;
  (c) Professional competence and due care;
  (d) Confidentiality; and
  (e) Professional behaviour. (SQC 1)\textsuperscript{67}

- There should establishment of policies and procedures designed to provide a reasonable assurance that the firm and its personnel subject to independence requirements and maintain independence. Such policies and procedures should enable the firm to: (a) Communicate its independence requirements to its personnel and others subject to them; and (b) Identify and evaluate circumstances and relationships that create threats to independence, and to take appropriate action to eliminate those threats or reduce them to an acceptable level by applying safeguards, or, if considered appropriate, to withdraw from the engagement.(SQC 1)\textsuperscript{68}

- The policies and procedures designed to provide a reasonable assurance should require:

  (a) Engagement partners to provide the firm with relevant information about client engagements including the scope of services. This enables the firm to evaluate the overall impact on independence requirements;
  
  (b) Personnel to promptly notify the firm all of the circumstances and relationships that create a threat to independence; and
The accumulation and communication of relevant information to appropriate personnel so that:

(i) The firm and its personnel can readily determine whether they satisfy independence requirements;
(ii) The firm can maintain and update its records relating to independence; and
(iii) The firm can take appropriate action regarding identified threats to independence. (SQC 1)

SQC 1 requires firm to establish policies and procedures designed for breach of independence requirements and to enable it to take appropriate actions to resolve such situations. The policies and procedures should include requirements for:

(a) All who are subject to independence requirements to promptly notify the firm of independence breaches of which they become aware;
(b) The firm to promptly communicate identified breaches of these policies and procedures to:
   (i) The engagement partner who, with the firm, needs to address the breach; and
   (ii) Other relevant personnel in the firm and those subject to the independence requirements who need to take appropriate action; and
   (iii) Prompt communication to the firm, if necessary, by the engagement partner and the other individuals referred to in subparagraph (b)(ii) of the actions taken to resolve the matter, so that the firm can determine whether it should take further action. (SQC 1)

The standard recommends that at least annually the firm should obtain written confirmation of compliance with its policies and procedures on
independence from all firm personnel required to be independent. (SQC 1)

- For safeguarding impairment independence of auditor because of familiarity threat there should be set criteria for determining the need for safeguards to reduce the familiarity threat to an acceptable level when using the same senior personnel on an assurance engagement over a long period of time; and for audit of listed entities requirement of rotating of engagement partner after a specified period in compliance with the Code. (SQC 1)

- In case of listed entities, to protect the independence of the engagement partner because of familiarity threat, there should be rotated after a pre-defined period of seven years. (SQC 1)

1.7 INTERNATIONAL LEGISLATIONS FOR PROTECTION OF AUDITOR’S INDEPENDENCE

The issue Auditor’s Independence is topic of hot debate around the globe. Around the world different jurisdiction have developed different regulations and standards to serve as a framework for auditing profession. A detailed discussion of two major regulations are:

1.7.1 Sarbanes - Oxley Act

The Sarbanes-Oxley Act (SOX) was enacted in 2002 in response to series of high profile financial scandals that occurred in the early 2000s at companies including Enron, WorldCom and Tyco that shattered trust of many stakeholders. The major provisions of this act for protection of Auditor’s independence are:

- Prohibition on Non-Audit Service

Under the act, a registered public accounting firm that performs audit is prohibited to provide following non-audit services along with audit service:

1. Bookkeeping or other services related to the accounting records or financial statements of the audit client;

2. Financial information systems design and implementation;
(3) Appraisal or valuation services, fairness opinions, or contribution-in-kind reports;

(4) Actuarial services;

(5) Internal audit outsourcing services;

(6) Management functions or human resources;

(7) Broker or dealer, investment adviser, or investment banking services;

(8) Legal services and expert services unrelated to the audit; and

(9) Any other service that the Board determines, by regulation, is impermissible.

It is also provided that a registered public accounting firm may engage in any non-audit service, including tax services, that is not described in any of paragraphs (1) through (9) for an audit client, only if the activity is approved in advance by the audit committee.(Sarbanes - Oxley Act)

➢ Preapproval Requirements

(a) Preapproval requirements are -

• Audit committee actions - All auditing services and non-audit services, other than as provided above, provided to an issuer by the auditor shall be preapproved by the audit committee of the issuer.

• de minimus exception - The preapproval requirement under subparagraph (a) is waived with respect to the provision of non-audit services for an issuer, if—

(i) the aggregate amount of all such non-audit services provided to the issuer constitutes not more than 5 percent of the total amount of revenues paid by the issuer to its auditor during the fiscal year in which the non-audit services are provided;

(ii) such services were not recognized by the issuer at the time of the engagement to be non-audit services; and
(iii) such services are promptly brought to the attention of the audit committee of the issuer and approved prior to the completion of the audit by the audit committee or by 1 or more members of the audit committee who are members of the board of directors to whom authority to grant such approvals has been delegated by the audit committee. (Sarbanes - Oxley Act)

- Disclosure to investors—Approval by an audit committee of an issuer under this subsection of a non-audit service to be performed by the auditor of the issuer shall be disclosed to investors in periodic reports. (Sarbanes - Oxley Act)

- Rotation of Audit Partner

   As per the act the lead (or coordinating) audit partner (having primary responsibility for the audit), or the audit partner responsible for reviewing the audit is required to be rotated after period of 5 years. (Sarbanes - Oxley Act)

- Auditor reports to audit committees

   For enhancement of Auditor’s Independence the registered public accounting firm that performs audit shall timely report to the audit committee —

   (1) All critical accounting policies and practices to be used;

   (2) All alternative treatments of financial information within generally accepted accounting principles that have been discussed with management officials of the issuer, ramifications of the use of such alternative disclosures and treatments, and the treatment preferred by the registered public accounting firm; and

   (3) Other material written communications between the registered public accounting firm and the management of the issuer, such as any management letter or schedule of unadjusted differences. (Sarbanes - Oxley Act)

- Conflicts of Interest

   A registered public accounting firm is prohibited to perform audit if a chief executive officer, controller, chief financial officer, chief accounting officer, or any
person serving in an equivalent position for the client company, was employed by that registered independent public accounting firm and participated in any capacity in the audit of that client during the 1-year period preceding the date of the initiation of the audit (Sarbanes - Oxley Act)\textsuperscript{78}

1.7.2 The Financial Aspects of Corporate Governance (Cadbury Committee)

The Cadbury Report, titled Financial Aspects of Corporate Governance, is a report issued by “The Committee on the Financial Aspects of Corporate Governance”. The report sets out recommendations to mitigate corporate governance risks and failures. Some of major recommendations for auditing profession are:

- **Development of Accounting Standard**

  The committee recommends development of more effective accounting standards. Such accounting standards provide important reference points against which auditors exercise their professional judgment. The position of an auditor is strengthened if standards do not allow alternative accounting treatments (Cadbury, 1992).\textsuperscript{79}

- **Formation of Audit Committee**

  It is recommended that every listed company should have an audit committee which gives auditors direct access to the non-executive members of the board. An audit committee is expected to ensure that the relationship between the auditors and management remains objective and that the auditors are able to put their views in the event of any difference of opinion with management (Cadbury, 1992).\textsuperscript{80}

- **Prohibition on Non-Audit Services**

  To strengthen the objective relationship between auditors and management, it is recommended that audit firms should not provide other types of service to their audit clients. The argument runs that such a prohibition would remove any pressure on the auditors to give way to management on audit matters in order not to jeopardize their other business services; and that it would remove any incentive for
auditors to take on audits at rates which could risk corner-cutting in the hope of obtaining more remunerative non-audit work (Cadbury, 1992).\textsuperscript{81}

\begin{itemize}
\item \textbf{Rotation of auditors}
\end{itemize}

To prevent development of familiar relationship between auditor and client some form of compulsory rotation of audit firms is recommended. The Committee has felt that any advantages which this could bring would be more than outweighed by the loss of the trust and experience which are built up when the relationships are sound, and by the risk to audit effectiveness at the changeover. The Committee has agreed, however, that in the case of listed companies a periodic change of audit partners should be arranged to bring a fresh approach to the audit (Cadbury, 1992).\textsuperscript{82}

\section{1.8 REFERENCES}


41 Companies Act 1956, Sec. 226

42 Companies Bill 2009, 15th Loksabha. Chapter X, para. 10.8.

43 Companies Bill 2009, 15th Loksabha. Chapter X, para. 10.10

44 Companies Bill 2009, 15th Loksabha. Chapter X, para. 10.48

45 Companies Bill 2009, 15th Loksabha. Chapter X, para. 10.49

46 Companies Bill 2009, 15th Loksabha. Chapter X, para. 10.55

47 Corporate Governance Voluntary Guideline (2009). Ministry of Corporate Affairs. IV, para A.

48 Corporate Governance Voluntary Guideline (2009). Ministry of Corporate Affairs. IV, para B.

49 Corporate Governance Voluntary Guideline (2009). Ministry of Corporate Affairs. IV, para C.


53 Naresh Chandra Committee on Corporate Audit and Governance (2002). Department of Corporate Affairs. Recommendation No. 2.0.

54 Naresh Chandra Committee on Corporate Audit and Governance (2002). Department of Corporate Affairs. Recommendation No. 2.2.
55 Naresh Chandra Committee on Corporate Audit and Governance (2002). Department of Corporate Affairs. Recommendation No. 2.3.

56 Naresh Chandra Committee on Corporate Audit and Governance (2002). Department of Corporate Affairs. Recommendation No. 2.4.

57 Naresh Chandra Committee on Corporate Audit and Governance (2002). Department of Corporate Affairs. Recommendation No. 2.8.

58 Naresh Chandra Committee on Corporate Audit and Governance (2002). Department of Corporate Affairs. Recommendation No. 3.1.

59 Naresh Chandra Committee on Corporate Audit and Governance (2002). Department of Corporate Affairs. Recommendation No. 3.2.

60 Companies Act 2013, Chapter X, Sec. 141(3)

61 Companies Act 2013, Chapter X, Sec. 139.

62 Companies Act 2013, Chapter X, Sec. 144.

63 Companies Act 2013, Chapter X, Sec. 147.

64 SA 220 (Standard on Quality Control of Audit of Financial Statement). ICAI. Para.11, Pg. 6.


66 SA 200 (Overall Objectives of an Independent Auditor and Conduct of an Audit in Accordance with Standard on Auditing). ICAI. Para 16.

67 SQC 1 (Standard on Quality Control). ICAI Para 15, Pg. 7

68 SQC 1 (Standard on Quality Control). ICAI Para 18, pg. 8

69 SQC 1 (Standard on Quality Control). ICAI Para 19, pg. 10

70 SQC 1 (Standard on Quality Control). ICAI Para 20, pg. 10

71 SQC 1 (Standard on Quality Control). ICAI Para 23, pg. 10

72 SQC 1 (Standard on Quality Control). ICAI Para 25, pg. 10

73 SQC 1 (Standard on Quality Control). ICAI Para 27, pg. 10
74 Sarbanes Oxley Act (2002). Title II, Sec. 201
75 Sarbanes Oxley Act (2002). Title II, Sec. 202
76 Sarbanes Oxley Act (2002). Title II, Sec. 203
77 Sarbanes Oxley Act (2002). Title II, Sec. 204
78 Sarbanes Oxley Act (2002). Title II, Sec. 206