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# INDEPENDENCE OF AUDITORS*

Professional integrity and independence is an essential characteristic of all the learned professions but is more so in the case of accounting profession. Independence implies that the judgement of a person is not subordinate to the wishes or directions of another person who might have engaged him, or to his own self-interest.

It is not possible to define "independence" precisely. Rules of professional conduct dealing with independence, like other rules, are framed primarily with a certain objective. The rules themselves cannot create or ensure the existence of independence. Although by now it has become somewhat trite to say so, independence is a condition of mind and personal character and should not be confused with the superficial and visible standards of independence which are sometimes imposed by law (and which are referred to below). These legal standards may be relaxed or strengthened but the quality of independence remains unaltered.

In all phases of a Chartered Accountant's work, he is expected to be independent, but in particular in his work as auditor, independence has a special meaning and significance. Not only the client but in the case of companies, also the shareholders, prospective investors, bankers and government agencies rely upon the accounts of an enterprise when they are audited by a Chartered Accountant. As statutory auditor of the accounts of a limited company, for example, the Chartered Accountant would cease to perform any useful function if the persons who rely upon the accounts of the company do not have any faith in the independence and integrity of the Chartered Accountant. In such cases he is expected to be objective in his approach, fearless, and capable of expressing an honest opinion based upon

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* This note replaces the note published in 'The Chartered Accountant', June 1968, p. 670--672.

the performance of work such as his training and experience enables him to do.

The idea of independence is instilled in the minds of Chartered Accountants from the commencement of their training under articles or audit service. It has to be applied in their day-to-day work and their success is dependent entirely upon their integrity, competence and independence of approach.

Dependent as it is on the state of mind and character of a person, independence, is a very subjective matter. One person might be independent in a particular set of circumstances. While another might feel he is not independent in similar circumstances. It is, therefore, the duty of every Chartered Accountant to determine for himself whether or not he can act independently in the given circumstances of a case and quite apart from legal rules, in no case to place himself in a position which would compromise his independence.

Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons. The relationship between the auditor and his client should be such that firstly, he is himself satisfied about his independence and secondly, no unbiased person would be forced to the conclusion that, on an objective assessment of the circumstances, there is likely to be an abridgement of the auditors' independence.

In order to ensure independence, the law has made certain provisions which either prohibit the appointment of a person as auditor in certain circumstances or place certain restrictions on his appointment as auditor or put third parties on guard against the possibility of an abridgement of independence by requiring certain disclosures to be made. These provisions are briefly outlined below :

Section 226 of the Companies Act, 1956 prohibits the appointment of a Chartered Accountant as auditor of a company 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. 1,000;

(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. 1,000.

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

Section 314 makes separate provision for the case where an auditor of a company (whether public or private) is a relative of a director, or manager of a private company of which the director of the company is a director or member. In the case of such a person, he may be appointed as auditor of a company only if such appointment is approved with the consent of the company in general meeting obtained by a special resolution.

It will be observed from the above that the Act has specifically provided for cases where the independence of an auditor may be affected by his connection with the company and prohibited or restricted him from acting as auditor under those circumstances.

A question often arises as to whether an indebtedness (as referred in para (iii) above) arises in cases where in accordance with the terms of his engagement by a client (e.g. resolution passed at the general meeting), the auditor recovers his fees on a progressive basis as and when a part of the work is done without waiting for the completion of the whole job. In these circumstances, where in accordance with such terms, the auditor recovers his fees on a progressive basis he cannot be said to be indebted to the company at any stage.

A question of indebtedness may also be raised where an auditor of a company purchases goods or services from a company audited by him. In such a case, if the amount outstanding exceeds Rs. 1000/-, irrespective of the nature of the purchase or period of credit allowed to other customers, the provisions concerning disqualification of auditor as contained in Section 226 (3) (d) will be attracted.

Another question which arises for consideration is whether a partner is disqualified from appointment as auditor when the firm of which he is a partner is indebted to the company in excess of the limit prescribed and whether the firm is disqualified from appointment as auditor when a partner of the firm is indebted in excess of the prescribed limit. In both cases, the disqualification will apply, because when a firm is appointed as auditor, each partner is deemed to be so appointed and when a firm is indebted, each partner is deemed to be indebted.

There may also be situations in which, though the appointment is in the individual name of a partner, the work is, in fact, carried out by the firm and the fees are credited to the account of the firm. In such situations, the firm will be deemed to be acting as auditor and the disqualification will be attracted.

The Chartered Accountants Act, 1949 (paragraph 10 of the First Schedule) prohibits acceptance of, what have been described as contingent fees, i e., fees, which are either based on a percentage of profits or otherwise dependent on the finding or the results of employment. An example would be a fee for tax work expressed as a percentage of refunds obtained. Exceptions to this rule have been specified in certain cases. For example, in the following cases, persons other than Chartered Accountants are also appointed for such work and a scale of remuneration based on results is provided for by law or practice:

(i) In the case of a receiver or a liquidator, the fees may be based on a percentage of the realisation or disbursement or of the assets.

(ii) In the case of an auditor of a co-operative society, the fees may be based on a percentage of the paid-up capital or the gross or net income or profits,

(iii) in the case of a valuer under the Estate Duty Act and the Wealth Tax Act, the fees are based on a percentage of the value of the property or of the wealth.

The Chartered Accountants Act (the Second Schedule, Part I, paragraph 4) makes it an act of misconduct for a Chartered Accountant to express an opinion on financial statements of a business in which he or his firm or a partner of his firm has a substantial interest unless disclosure of such interest is made. Such disclosure will put every reader of the financial statement on guard against any possibility of an impairment of the independence of the Chartered Accountant signing the report. So long as disclosure of interest is made, there is nothing in law to prohibit a Chartered Accountant from expressing an opinion in such cases. However, in appropriate circumstances, and particularly when the Chartered Accountant considers that there is a likelihood of the very existence of such interest leading an unbiased reader to the assumption that the auditor's independence is likely to be affected, the Chartered Accountant would be well advised to refrain from expressing a professional opinion.

The Act does not define the phrase "substantial interest".* This is just as well, as it has to be left to the judgment and discretion of the Chartered Accountant to determine the extent of interest which would affect his independence. He would be well advised to satisfy himself that the decision in this regard is such as would be taken as reasonable by an objective third party in the circumstances of the case.

The Chartered Accountant must take care to see that he doss not get into situations where there could be a conflict of interest and duty. For example, where a Chartered Accountant is appointed the liquidator of a company, he should not himself audit the Statement of Accounts to be filed under Section 551 (1) of the Companies Act, 1956. The audit in such circumstances should be done by *a* Chartered Accountant other than the one who is the liquidator of the company.

It would be observed that the law does not prohibit persons holding shares in the capital of a company, from being appointed as auditors, nor is there any restriction on their buying or selling such shares. While a blanket ban upon a person investing his personal savings in the shares of a company would be extremely unfair under Indian conditions, any imposition of monetary ceilings would be equally difficult to work in practice

However, it needs to be added that the auditor should not make use of the information which comes into his possession, during his audit to buy or sell the shares of a company, which is being audited by him. Indeed transactions for large purchases or sale in case of companies which are audited by him should be avoided particularly under circumstances where an inference could be drawn that improper use of internal information has been made.

The auditor of a partnership business or of a private company may sometime be invited to advise where there is an internal disagreement in the firm or company. In such cases care should be taken before accepting such invitation by examining all attendant circumstances to ensure that the auditor's position of independence in relation to the performance of his work

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* Though the Act does not define 'substantial interest', Notification No. 1-CA (44)71 dated 20th March, 1971, issued by the Council regarding audit of entities in which the 'relatives' of the auditor have substantial interest has defined the expression as having the same meaning as is assigned under Explanation 3 to Section 13 of the Income Tax Act, 1961.

as auditor is not in any way prejudiced. There may be many cases where it would be desirable to decline such work, but equally there may be cases where by virtue of his professional competence and integrity he is particularly well suited to settle disputes of this nature.

An auditor may prepare or assist in the preparation of the accounts of a company before proceeding to audit them, or agree to provide financial advice or to represent the company for its tax matters without impairing his independence in any way. These functions are often complementary in character to the performance of the function of the auditor.

One of the matters concerns the appointment as auditors of partners who are relatives of Managing Director or Whole Time Director. It has been mentioned that in such instances where close relationship exists, it is possible that the independence of an auditor may be jeopardised.

The Council feels that there are adequate safeguards provided in the Companies Act as well as in the Chartered Accountants Act. It is of the view that independence, being a state of the mind, is not necessarily affected by the fact of mere relationship any more than it should be in existence if the relationship did not exist. In any case, lest there may be any feeling in the public mind that relationship would affect the independence of auditors, the Council suggests that where, due to near relationship of an auditor with a Managing or a Whole-Time Director, the independence of an auditor is likely to be jeopardised, he should use his good sense, and acting in the best traditions of the profession, refrain from accepting the appointment.

Similarly, if an auditor is a relative of a Director other than a Managing or a Whole Time Director, the partner of the firm who is so related may not, if he feels that his independence is likely to be affected, perform the audit but should leave it to another partner of the firm.