excellence enablers CORPORATE GOVERNANCE SPECIALISTS (AN M. DAMODARAN INITIATIVE)

Expert Expressions
Corporate Governance Demystified

Excellence Enablers Private Limited November|2019

If SEBI comes, can MCA be far behind? The ink was hardly dry on the SEBI circular on auditor resignations, when MCA notified the requirement of a qualifying test for Independent Directors. We discuss the exit and entry environment.

Editor

EGRESS AND INGRESS

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"Jaana hai to jao, bulayenge nahin" no longer holds the field for auditors. They have recently discovered, courtesy a SEBI circular, that resignation is no longer an event, but has transformed into a process.

The spate of auditor resignations has been a matter of concern for all stakeholders for quite some time. Since audit is the function that lends credibility to financial statements, the unscheduled departure of an auditor gives rise to questions regarding the legitimacy of those statements. So, for auditors to walk away in cavalier fashion, as soon as a small degree of discomfort is experienced, can never be a preferred option as far as stakeholders are concerned. Overstaying one's welcome could also lead to grievous consequences. Clearly therefore, resignation is a decision that cannot be taken too early or left too late.

SEBI has now spoken. When an auditor should resign, what she should do before she resigns, and what reasons she should set out for the resignation, constitute the subject matter of the recent circular. It goes on to state what the recipient of the resignation letter should do, and when. Like many answers, this one also throws up a few questions. But first, the prescription. The requirement, which now stands amended or refined, was that the detailed reasons for the resignation of an auditor of a listed entity should be disclosed to the stock exchanges as soon as possible, but not later than 24 hours of receipt of such reasons from the auditor. It is reasonable to presume that an auditor, when communicating a serious decision such as a resignation, would also indicate the reasons therefor. The time limit indicated would seem to preclude any discussions between the Audit Committee (AC) and the auditor, and consequently, any opportunity for the AC to intervene constructively. Until now, the company was reduced to performing the function of a post office, communicating the decision of the auditor to the exchanges. Things have changed.

Prior to resignation, the auditor shall "approach" the Chairperson of the AC with concerns such as non-availability of information or non-cooperation by the management, and the AC shall receive such concerns "directly and immediately". This is presumably to provide the AC with an opportunity to take such corrective action, as is possible. What is not elaborated, but is procedurally most appropriate, is for an AC meeting to be convened at short notice, and for the Committee members, without the presence of any management element, to hear the concerns of the auditors. Thereafter, the Committee could hear the management version of its alleged non-cooperation or non-furnishing of information. If the AC is unable to resolve the matter, the auditor's resignation should be accepted, and should be communicated to the exchanges.

There are some issues that cannot be lost sight of. In a rare case, where the auditor has a general sense of discomfort and would like to leave, it is entirely possible for the auditor to prepare a long list of documents and information required, and to indicate a very short time limit for the management to comply. If the deadline is breached, the auditor could then say that the information has not been furnished, and could then leave. There is also the larger question of the auditor's state of mind. It is reasonable to believe that a responsible functionary, such as an auditor, would contemplate resignation only after examining all possible alternatives. When she approaches the AC, indicating an intention to resign, it is highly unlikely that the AC will be able to satisfy the concerns of the auditor. Will the revised procedure not amount to an infructuous exercise?

There is also the issue of alleged non-cooperation. In a recent case, the auditor reached the factory gates, only to find it closed, and to be denied admission by the guard. The auditor alleged non-cooperation. The management claimed that the guard had no prior notice of the intended visit of the auditor, and therefore did not let her in. This is a situation in which neither side covered itself with glory. It was not rocket science for the auditor to request a management functionary to accompany her or to pass on information to the guard that the auditor would be visiting.

The recent regulatory intervention also provides for the manner in which an auditor should deal with the issue of limited review or audit report, if the resignation happens during a quarter. The circular contemplates *inter alia* that **if an auditor resigns** after 45 days from the end of a quarter, the auditor shall, before such resignation, issue the limited review or audit report for such quarter, **and for the next quarter**. With resignation, the auditor becomes *functus officio*. It would be incorrect for her to issue or authenticate any report post her resignation since it will have questionable legal validity. There is also the question of the mental state. What interest can an auditor or any person have, post his resignation, to undertake a detailed inspection or audit, and to engage with management, in order to finalise comments for inclusion in the report? Why not use the sensible formulation of "proposes to resign" which figures in one part of the circular, and replace "if an auditor resigns"?

In this entire exercise, roles have been assigned to the auditor, the AC, the Chairperson of the AC, the Board and the exchanges. There is one missing element and that is the shareholder. It is inadequate for her to receive cryptic information, through the medium of a disclosure on the exchange. The assumption that all shareholders keep track of what is published on the website of exchanges is also questionable. Since it is the admitted position, at least for form's sake, that the shareholders approve the appointment of statutory auditors, it stands to reason that outgoing auditor, post her resignation, should appear before the shareholders at the next Annual General Meeting (AGM), offer an explanation, and be prepared to respond to queries that shareholders might have in regard to the reasons for, and the circumstances of, the resignation. This, more than a sterile disclosure to the exchanges, would be a manifestation of shareholder democracy.

As for auditors, life has become more complex. When rotation was first mooted, the auditors threatened a revolution. With rotation having been mandated, they scrambled for audit assignments. Now that they have got new audits, at least some of them are asking themselves whether they have landed in the right place. Having battled to get in, a premature exit is not an easy decision. The longer one stays in a company with questionable practices, the more one becomes a part of the problem. Knowing when to leave is critical.

While auditors could find their exit difficult, Independent Directors (IDs) will have to contend with a new entry barrier. Getting 60% in an online "proficiency self-assessment test" will open the gates to boardrooms. Remember however that eligibility is not entitlement.

The test that will *inter alia* define fitness will cover "Companies (sic) law, securities law, basic accountancy", and such other areas of relevance. If this is the line of treatment decided on for ailing Boards, it would be useful to step back and look at the diagnosis.

Boards, the world over, have underperformed for a number of years. Both Enron and Satyam, to take just two examples, had marquee Boards, with lawyers and men of finance aplenty. Did they fail because of ignorance of law or finance? In recent corporate history, IL&FS has been a monumental failure. Yet, those Boards had, person for person, IDs that, on the basis of their qualifications and experience, most Boards would have given an arm and a leg for.

Clearly the problems lie elsewhere, and the proposed test is not even remotely relevant. It is no secret that IDs were selected mostly on the basis of comfort levels, clubbability and their being convenient. Peaceful coexistence was the watchword. The constructive tension that ought to exist between the Board and the management rarely figured even in academic conversations.

Enlightened Boards and promoters know that value addition lies in moving from the convenient to the competent. Relevance, rather than relationships, ought to be the key to the boardrooms.

Will the proposed test be an indicator of the maturity and wisdom that resides in Boards, or will it legitimise learning by rote which is, or ought to be, discredited and discontinued even in schools?

It is no one's case, that new Directors, however accomplished, might need some handholding. Well-intentioned companies that see Boards as value adding entities could introduce a system where the senior most IDs mentor the new IDs in an informal unstructured manner. Yet another matter should not be lost sight of. Inclusion, as well as renewal, of a name in the databank comes at a price. Relevance of the test notwithstanding, the revenue stream of the notified institute has been taken care of.

One last thought. Hopefully, the question paper will not be as peppered with the definitive article "the", as the application form is!

For our views on PMC Bank, "As Safe As a Bank", please click here.

GATEKEEPERS OF GOVERNANCE
A Corporate Governance Summit

Date: 21st – 22nd November, 2019
Venue: Hotel Trident, Bandra Kurla Complex, Mumbai

INAUGURAL SESSION

at 10am on Thursday, 21st November, 2019

Looking Forward, Looking Back

Mr. Kumar Mangalam Birla
Chairman, Aditya Birla Group

in conversation with **Mr. M. Damodaran**

PLENARY SESSION

at 9.45am on Friday, 22nd November, 2019

Corporate Governance – Missing the Wood for the Trees

Ms. Kiran Mazumdar Shaw
Chairperson and Managing Director, Biocon

in conversation with **Mr. R. Gopalakrishnan**
Former Director, Tata Group companies

Do let us know of any specific issues you would like to see addressed in subsequent issues.