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# FOR A BETTER FUTURE

*Corporate Governance is always work in progress. In this newsletter we touch on some concerns and priorities.*

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For some time now, auditors and Audit Committees (ACs) have been the subject of relentless scrutiny by the Regulators and by several other stakeholders. Reflecting this increasing concern, a Whole-time Member of SEBI very recently advised the audit professionals to be extra careful when auditing the accounts of SMEs. While the observation might have contextual validity, it is useful to remember that size of the auditee is no guarantee of good conduct. There have been, and continue to be, transgressions, and worse, that auditors have either not caught on to, or glossed over, as far as large companies are concerned.

NFRA has recently observed that ACs cannot hide behind auditors. What is perhaps intended is the advice that the AC must challenge the auditors sufficiently, to get at the true state of affairs, as far as the financial statements are concerned. Needless to say, auditors should push back strongly to see that the AC raises the questions it needs to raise, to get management to stick to the straight and narrow path.

This is a fairly logical and a simple expectation. It is therefore useful to see why it does not play out with as much regularity, as stakeholders would like it to.

In a recent roundtable that Excellence Enablers conducted, one of the issues highlighted was that the ACs were not equipped in terms of expertise or experience to discharge their multifarious responsibilities. While the Chairperson of the AC would be a well versed financial professional, who can assure a constructive interaction with the auditors, the requisite expertise is not available with most of the members. In some ACs, therefore, they remain occupants of ringside seats, while the Chairperson and the auditors engage in a productive conversation. This situation goes to the root of the constitution of the AC. This is best illustrated by a recent case in which a senior retired person from the armed forces mentioned to the regulatory agency that he did not have the requisite expertise to ask the right questions, nor was he told that it would be required, before he was made a member of the committee. Being a former senior professional from the services, he was predictably forthright. This cannot be said of several other members who effectively hide their ignorance, while AC meetings take place. The problem perhaps is that the way the Boards are composed, they do not have enough persons with an adequate knowledge of accounts or audit to be made members of the AC. Their understanding of the business could also be patchy.

Given the significant role of the AC, anything that emerges therefrom is almost routinely lapped up by the Board, without discussion or debate. Therefore, unless the composition is addressed, and an adequate number of persons, with the requisite experience, are placed in ACs, the problem is unlikely to go away in a hurry. Courses such as finance for non-finance executives can travel thus far, and no further.

One of the shocking conclusions that emerged from the roundtable was that there was an acute shortage of auditing personnel of good quality at the entry level in audit firms. With the restriction in the number of persons who pass the CA examinations, the broader universe has somewhat shrunk. More to the point, many of the newly qualified CAs do not consider audit as a worthwhile career choice for a variety of reasons. Many of them gravitate to secure jobs in corporates, or join startups, or as has been noticed for quite some time, opt for investment banking, or some such rewarding career options. With an increasing number of listed entities, and a significantly large number of unlisted entities, there is a perpetually increasing demand for auditors. If there are supply side constraints, getting quality audits done of an increasingly large number of firms is going to remain a major challenge. It would be for the professional representative body to get to grips with this problem, and to put in place worthwhile solutions, without loss of time.

In recent months, NFRA has come down heavily on auditors and audit firms, who have been found to be remiss in ensuring the quality of audit. Understandably, this has introduced a sense of deep disquiet in the auditing profession, especially considering that the firms and auditors being pulled up, and punished, belong to the largest audit firms.

If supply constraint is a problem in the auditing profession, the opposite is true of Independent Directors (IDs). A recent article has shown that as against a total of 9,603 positions of IDs on 2,394 listed corporate Boards, there are 31,151 persons who have qualified in the certification process, and got themselves enlisted in the databank mandated by the Government. It can be no one's case that notwithstanding their having qualified in the examination, all these candidates are ready to hit the ground running. India is perhaps the only jurisdiction which has prescribed a qualifying examination, and consequent registration for IDs. There is no evidence to show that corporates, looking out for suitable candidates to fill Board vacancies, are making use of the database that the Government sponsored institute has compiled. To address this, the institute has recently reached out to search/ headhunting firms, requesting them to make use of the database that exists. Knowing the elaborate process which search firms go through, to identify suitable candidates, it is unlikely that the databank would be their first port of call. What will then result, if it has not already happened, is that persons whose names are on the databank, will have an increasing sense of frustration and demotivation at their not having been approached by any corporate for any position on the Board. The fact that they have paid a significant sum of money to remain on the databank further compounds the problem.

While focusing on auditors, ACs, IDs and Regulators, it is useful to remember that companies exist for the purpose of carrying out business. Too many restrictions, which are frequent and disruptive, will tend to adversely impact the ease of doing business. At the same time, Directors and auditors who do not measure up, will ensure that stakeholders lose confidence in the entire system, and look for other opportunities, including other asset classes. The task at hand is to ensure that the legitimate expectations of stakeholders are addressed, by ensuring a quality Board, and the existence of auditors who do not pull their punches, and cannot be easily fobbed off. Considering that these problems can be fixed only by a number of Regulators/ institutions sitting together, and looking into the future, it is necessary to get this consultative and corrective process started, and not to leave it too late, since the luxury of time is not available. There must be adequate fora at which each of these constituents exchange their experiences, and learn from the wisdom that resides elsewhere. As we have said earlier, experience is not the name that you give to your mistakes alone.

The excesses of a few promoters make shareholders look askance at the promoters of even well-governed companies. There is considerable truth in saying that IDs exist to save promoters from themselves. In the process, they will also be ensuring fulfilment of the legitimate aspirations of all stakeholders.

India, it must be remembered, is a large and growing market, which will see far more companies getting listed in the days ahead. In addition to qualified finance professionals, there will be a need for auditors with the right experience and quality. There will also be a need for good IDs to complement the role played by executive management, to ensure that growth and governance run hand in hand, especially in newly listed companies. Tinkering with the provisions of the Act and the regulations should be put on the backburner, while the apex bodies devote focused time and effort to address these systemic concerns.

Yet another area of concern is the adequacy of sufficiently experienced Chief Financial Officers (CFOs) in these challenging times. It is now increasingly recognised that the CFO is not a controller of accounts, as was wrongly believed in the past, but a very senior individual, who serves as a copilot of management, alongside the CEO. Clearly, a pure finance professional, with no other attributes, will not tick the box. It is necessary to have a sound understanding of business, and the external environment, in order to complement the efforts of the CEO to craft the appropriate strategy for the present and the future. There is no clarity whether CFOs, especially in the smaller companies, have the requisite wherewithal to measure up to the increasing and diverse demands that are placed on the CFO. No matter how well CFOs are compensated, there would be a tendency to move to start ups, and to bet on aligning their future growth and prosperity with that of the startup. This too could lead to loss of experienced professionals to head the finance function of large and medium corporates.

The constructive nature of the audit function, including that of the AC, depends significantly on a sound understanding of the business of the auditee company. This will ensure that audit is not seen as a fault-finding function, but as a value-adding element in the conduct of business of the company. Some companies ensure that in the finance and audit function, there is a small complement of persons who have directly discharged business responsibilities. This approach should inform the constitution of the AC, as well as the very critical function of internal audit, where in the absence of understanding of business, highly theoretical observations and objections could surface.

In the interest of the corporate ecosystem, it might be useful, even for large corporates to take a lead role in helping the smaller entities to measure up to speed, including by identifying the gaps that need to be filled, and aiding in the putting in place robust processes and practices.

Every organisation, product or process benefits considerably from periodic evaluation. It is contextually relevant to mention that if Boards and committees, especially the AC, are to satisfactorily discharge their duties, a robust evaluation mechanism should be put in place to identify shortcomings, and to persuade the Board to address those shortcomings. The stand "my Board has no problem" is the biggest problem that Boards need to address quickly and comprehensively.

Que sera sera won't work. The future is ours to see.