JLN.1. NO.1. SEPTEMBER 1989.

JURNAL AKADEMIK

The Art of Modelling	YAP YIN @ YAP KEE KONG
Employment: Focus on Housework	WEE CHONG HUI
Evaluating Effectiveness of Teaching	SICK GOH NGONG
Towards A More Meaningful Financial Statement	WEE SHU HUI
The Independence of the Auditors – Fact or Fantasy	ALLAN CHANG AIK LENG
Masalah Pembelajaran Pelajar-Pelajar Institut Teknologi Mara Cawangan Sarawak	HAMIDAH ABDUL NINGGAL
Prinsip-Prinsip Pembentukan Huruf Cina	LOW KUEK LONG
Perkembangan Imbangan Pembayaran Malaysia 1978-1987	ROSITA HJ. SUHAIMI

ISSN 0128-2635

INSTITUT TEKNOLOGI MARA CAWANGAN SARAWAK

THE INDEPENDENCE OF THE AUDITORS – FACT OR FANTASY

by

Allan Chang Aik Leng

INTRODUCTION

This article analyses the auditors' dilemma in projecting their image of independence in appearance and in fact. The first part will discuss the statutory provisions and ethical considerations aimed at projecting the auditors' independence in the audit of limited companies. The second part will detail the problems which arise in practice and which threaten the auditors' independence.

Not all companies, whether private or public, are subject to an audit. Only companies which are registered under the Malaysian Companies Act 1965 (as amended) are obliged to undergo an external audit at least once a year. These are "limited companies." In the event of a bankruptcy, the shareholders' liability is limited to the share capital they have contributed while their personal assets remain untouched.

On the other hand, companies or firms which are not registered under the Companies Act 1965 (such as sole proprietors or partnership) are not obliged under the law to have their accounts audited.

The rationale behind this distinction is that the law desires to protect the interests of outside parties, including those non-executive shareholders, creditors, bankers and other users of financial statements. The 'limited liability' of a company does mean that some members of the public who may not be aware of the company's financial standing could stand to loose considerably in uncollectable debts if the company becomes bankrupt. For instance, a trade creditor who has supplied goods to a limited company worth millions of ringgit may suddenly find out that the company has gone bankrupt and therefore, could not even recover the goods supplied if they have been sold. The trade creditor will not be able to sue the directors or shareholders because in law the company and the shareholders are separate entity and the shareholders liability is limited to the share capital they have contributed.

A sole proprietor or partnership, on the other hand, has unlimited liabilities. The firm and the partners are not separate entities in law, and the partners are severally and jointly liable for the debts of the firm. The same applies to a sole proprietor.

IMPORTANCE OF INDEPENDENCE OF AUDITORS

The auditors' independence is such a crucial issue to an auditor that, without it, he cannot perform his duties as an auditor. It is the very crux of his professionalism. The auditor must be seen to be independent and should be unbiased, honest and fair.

The auditor's duty is to report to the shareholders (referred to as 'members' in the Companies Act) stating, in his opinion, whether the financial statements as presented to them show a true and fair view of the state of affairs of the company for the period being audited. The audit should be done before the accounts are presented to them in the annual general meeting which all members are entitled to attend. His main function is, therefore, to protect the interests of the non-executive shareholders who are not aware of what is happening in the company.

Theoretically, if there are no auditors, any shareholders may visit the company's premises to examine whether the accounts presented by the management show a true and fair view of the company's affairs. This could lead to havoc. If there are a thousand shareholders all wanting to do this, then the company's books of accounts would be soiled, and the resultant disruption of the company's recording process would render any production of management reports impossible. This is the reason why an auditor must be appointed. The auditor represents the shareholders. With his skill and professionalism, he is expected to report fairly and independently to the members.

PROTECTION OF AUDITOR'S INDEPENDENCE BY STATUTORY PROVISIONS

Section 9 of the Companies Act 1965 (as amended) states that[1] an auditor cannot be appointed

(a) If he is not an approved company auditor;

(b) If he is indebted to the company or to a corporation that is deemed to be related to that company in an amount exceeding $2,500;

(c) If he is

  (i) an officer of the company;

  (ii) a partner, employer or employee of an officer of the company;

  (iii) a partner or employee of an employee of an officer of the company;

  (iv) a shareholder or his spouse is a shareholder of a corporation whose employee is an officer of the company;

(d) If he is responsible for or if he is the partner employer or employee of a person responsible for the keeping of the register of members.

The above provisions mean that if the auditor owes his client an amount exceeding $2,500, he must not accept the appointment as auditor. This statutory provision is designed to ensure that the auditor must not be unduly influenced in drafting his audit report by the threat from his client to recall the loan immediately and thereby putting the auditor in a financial dilemma. The question is: Can the sum of $2,500 cause the auditor's independence to be threatened? The provisions were enacted in 1965 when a sum of $2,500 would probably be ten times more in value then it is today. Perhaps it is time that the statutory provisions be amended to reflect the current situation as inflaction has caused the above sum to be meagre. However, the statutory provisions do contain loopholes. Let us take an example, where the auditor owes his client $2,500 and to avoid infringing the Companies Act, he pays back one ringgit. This leaves a balance of $2,499! That certainly is not desirable.

The Companies Act forbids an officer or employee or partner or shareholder of the company to act as auditor of the same company. The rational is that if an officer or employee of the company is under the direct control of the management or the directors of the company, he cannot be independent in fact or in appearance.

An auditor cannot be a partner of the company. As a partner of the company, the auditor belongs to the management team, and the Companies Act requires the management to prepare the accounts and subsequently to audit them. If the auditor is also a partner of the company, then he will invariably audit his own work. This certainly makes the audit redundant.

---

[1] Laws of Malaysia, Act 125, Companies Act 1965, p.35

The Companies Act also forbids any auditor to become a shareholder of the company. As a majority shareholder, his conflict of interest is the same as that of a partner because he will certainly get elected as a director of the company. As a minority shareholder, his financial interest in the company may be in conflict with his duty as an auditor. When the company is in financial trouble, he may wish to sell his shares as high a price as is possible. If he reveals the actual situation of the company, he may not be able to do so because the investors may react to his report sensitively.

The Companies Act 1965 also forbids a person who is responsible for keeping the members register to act as auditor. The reasoning behind this is that the auditor will have to report whether the members register is properly kept in accordance with the Companies Acts, and if he were to maintain the member's register, he will be auditing his own work! This is certainly against the auditors ethics.

The Companies Act also states that an ex-officer of a company cannot be appointed as an auditor within twelve months from the date of his resignation from the company. This is to avoid a situation where an accountant of the company having been responsible for the preparation of the company's accounts, resigns and immediately being appointed auditor, thereby audits his own work!

Another important provision that protects the auditors' independence is their appointment and removal The appointment of auditors is normally done in the annual general meeting in which the shareholders elects them. The directors are not allowed to appoint auditors unless for purposes of expediency as in the following situations:

(i) The directors of the company may appoint an auditor at anytime before the first AGM of the company, but the auditor so appointed shall only be in office until the conclusion of the first AGM. The rational is that, if the company were to wait for an auditor to be appointed at the AGM, the accounts will never be audited in time for the said AGM.

(ii) The directors of a company may appoint an approved company auditor in cases where the appointed auditor dies or resigns. The company cannot afford to wait for the next AGM to appoint an auditor.

(iii) In exceptional cases when both directors and shareholders are unable to appoint an auditor, the Registrar of Companies, on the application in writing of any member of the company, may make the appointment.

Another piece of statutory provisions that protects auditors independence is that the removal of auditors can only be done in a general meeting in which only shareholders are entitled to attend and vote. The directors of the company cannot remove an auditor. It is ironical to note that the auditors are usually removed because they do an excellent job such as exposing the wrong doings and irregularities done by the directors. It is for this reason that the Companies Act provides stringent rules regarding removal of auditors. The rules are contained in Section 172 of the Companies Act 1965.[2]

(1) An auditor of a company may be removed from office by a resolution of the company at a general meeting of which special notice has been given, but not otherwise.

(2) Where special notice of a resolution to remove an auditor is received by a company:-

   (a) It shall forthwith send a copy of the notice to the auditor concerned and to the Registrar; and

---

[2]Companies Act 1965, subsection (4) and (5), p. 193

(b) The auditor may, within seven days after the receipt by him of the copy of the notice, make representation in writing to the company (not exceeding a reasonable length) and request that, prior to the meeting at which the resolution is to be considered, a copy of the representations be sent by the company to every member of the company to whom notice of the meeting is sent.

(3) Unless the Registrar on the application of the company otherwise orders, the company shall send a copy of the representation as so requested, and the auditor may require that the representations be read out at the meeting.

The above provisions are by no means easy to comply, but it is an important piece of legislation to protect auditors' independence. If an auditor is being removed because he has done an excellent job, he will have no fear of losing the audit job as he can defend himself in the general meeting in which the shareholders will decide on the matter. Naturally, it is expected that the shareholders will protect the auditor who has exposed any misdeeds of the directors. It did happen in England that the directors actually withdrew their intention to remove the auditors after the auditors defended themselves in accordance with the provisions of the Companies Act.

ETHICAL CONSIDERATIONS

There are a number of ethical considerations that ensure auditors' independence.

(1) Over dependence on a particular client, or a group of connected clients:
When an auditor receives a large portion of his gross fees from a client or a group, the auditor may be unduly influenced by his client for fear of loss of this particular audit job. For this reason, the professional bodies have fixed, as a guide, that the recurring fees received from a client or a group of connected clients should not exceed 15% of the gross fee of the practice.

(2) Conflict of interest in terms of roles:
The auditor may be caught in a difficult position when he is appointed adviser perhaps in an effort to help the client who is facing a financial crisis, and on the other hand, he may also be acting as auditor for the same client thereby being responsible for issuing a true and fair audit report. This would frustrate his efforts to save the company because as a management consultant, he may try his best to save the company by painting a good picture of the company's future prospects. He may not be objective. However, in his audit report he has to state his true and fair views of the company's current standing which may be so bad that no one would believe the company will survive. The auditor should avoid such a conflict of roles by accepting only one.

(3) Personal relationship with client:
The auditors professional code of ethics forbids any close relationship with the client as this could cause a loss of independence in appearance. It is, however, often argued that it is the auditors' friendship with the client that enables the auditor to retain his circle of clients. This point will be further elaborated.

(4) Benefits/Special treatment from clients:
The auditor cannot accept any goods or services and should neither accept terms more favourable than those available to the generality of the employees of the client. For example, if the employees of the company are entitled to buy goods for a special staff price, then the auditor may accept the same benefit.

THE PROBLEMS OF AUDITOR'S INDEPENDENCE IN PRACTICE

The Companies Acts were enacted to prevent a conflict of interests between auditors and clients in ensuring the auditors' independence. The professional code of ethics which dwells on the more salient points is of no less importance. The provisions in the professional ethics are rather difficult to implement and hence remain significant in theory only. In practice, the auditor may receive recurring fees from a group of clients exceeding 15% of his gross fees of the practice, but it is very difficult to prove so, let alone taking any displinary action against him. The auditor could combine his practice with that of other audit firms so that the audit fee from a particular client does not exceed the 15% limit while at the same time the same clients are retained.

The auditor finds it difficult to be completely independent in practice. In fact, complete independence is virtually unheard of. The reason is that it is practically impossible for the auditor to carry out his work if he sticks strictly to the requirements of the Companies Acts. The auditor needs the co-operation of the client. It is easier to do a job by co-operation rather than confrontation. For example, when the auditor asks for an explanation of a questionable payment of commission to a director, he may get the cold shoulder treatment or be met with silence. The auditor has to be tactful so as not to offend the directors concerned and perhaps wait until the directors concerned are in a good mood. If the auditor chooses to exercise his right and demands an explanation, the directors may react by giving false information which may mislead the auditor to direct his time on a wild goose chase. Finally, not only is the auditor unable to get the information required but he would have lost so much valuable time that he may not be able to complete his work in time. Consequently, the directors may accuse the auditor of being inefficient, and recommend his removal. Moreover, the directors may give another reason favouring his removal alleging that the audit fees may be increased since the auditor has taken too much time. The auditor himself may feel that his relationship with his client now has become so strained that it is not worthwhile doing the job. Consequently, he may not defend the intention of the directors to remove him. To summarise, the untactfulness of the auditor may cause him to loose clients, and consequently a shrinking of his business practice.

In some cases, having performed his work, an auditor may receive his fees later or may not be paid at all if he seeks to be too independent in carrying out his duty. Some clients may feel that the auditor has not done a good job because he is too strict and has qualified his reports. The client's financial reports which have been qualified by the auditor may jeopardize the client's chances of securing a bank loan. If his audit fees are not paid, a court action to recover the audit fees from the client may lead to his removal as auditor and a long and expensive legal battle would ensue. Cases have shown that qualifying an audit report may lead to a higher income tax after the investigation into the company's affairs by the Inland Revenue Department. With such a detrimental effect on the client, the auditor would not be expected to receive his audit fees.

Despite all these practical difficulties and frustration which seem to threaten the auditors' independence, the auditor can still carry out his duties independently and with dignity. It must be noted that complete independence may not be a reality or even not crucial to the audit of small private limited companies, as most of the directors are shareholders as well. What concerns us here is how the interests of creditors and the public at large can be protected. In practice, most creditors do not give credit to customers simply by looking at the accounts. There are many other factors to be considered including an analysis of the financial standing

and reputation of the managing director. As for the public, or potential investors, the accounts are not the only criterion for them to make an investment decision. There are factors like the reputation of the company.

Public companies, on the other hand, are being managed professionally and audited by big reputable audit firms, the auditors of which would never wish to compromise on the question of independence because if they are proved to be unprofessional in their work, their reputation and corporate image would drop leading to a loss of many big clients. In a dilemma of choosing between independence and a client, the former is their natural choice.

Therefore, it may be safely concluded that big audit firms would be able to exercise their full rights under the Companies Acts to conduct their work without fear or favour. The problem of the auditors' independence in practice seems to be confined to small private companies whose accounts are not targeted for public consumption. Therefore, the interest of the public is still safeguarded.

BIBLIOGRAPHY

Dommen, Baby T., **Specialised Audit, A Malaysian Emphasis,** 1st (Revised) Edition, University of Malaya Press, Kuala Lumpur, 1986.

Leslie, Howard, **Auditing,** ELBS and Macdonald and Evans, London, 1982.

"Liability of Auditors, **"Berita MIA: Malaysian Institute of Accountants,** June, 1988.

Millichamp, A – H., **Auditing,** DP Publications, New Hampshire, 1986.

Weir, Michael, "Audit Liability: A matter of opinion", **Certified Accountants, United Kingdom,** August 1988.

Woolf, Emile, "True & Fair: Auditing Practises", **Certified Accountants, United Kingdom,** August 1988.