The Role of Reputation Agents in Corporate Governance

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1. Introduction

In the context of corporate governance, reputation agents are those who provide assurance or endorse corporate communications based on which outsiders make decisions. Since the public relies on their statements of assurance, it is important that reputation agents maintain and enhance their own reputations with impeccable conduct at all times. In performing their duties, reputation agents should maintain high standards of personal and professional integrity, be objective in the advice they offer, and in certain circumstances (for instance, in the case of external auditors) ensure they are independent in substance and form. These reputation agents have a principal-agent relationship with those who appoint them—the relationship between shareholders and statutory auditors is a classic example. Reputation agents also have an indirect responsibility to stakeholders (for instance, regulators, employees and the media) who rely on the assurances they provide.1

2. Key approaches to corporate governance

The principal-agent model of corporate governance

In the classical principal-agent theory (otherwise known as agency theory), the relationship between owners (principals) and company managements (agents) is characterised by the delegation of the decision-
making authority to agents (Jensen & Meckling, 1976). The agent plays an instrumental role in studying the various dimensions of a business, like suppliers, costs, employees, customers, and/or investors. The agent is required to conduct his/her efforts in the best interests of the principal. However, as both parties are committed to maximising their own utilities, this model recognises the agency costs that materialise from the separation of ownership and control. Agents are likely to have motives that differ from those of their principals. There is thus a predisposition for certain conflicts of interest between the management, shareholders, and/or debt-holders. These mismatches of interest can arise from asymmetries in the distribution of earnings and/or information asymmetries. These asymmetries could lead to an eventuality where firms could take more risk than their appetites would otherwise allow.

Since it is not practically feasible for the principal to monitor the activities of agents at all times, there is a risk of opportunistic self-serving behaviour on the part of the agents. Principals can lack trust in their agents in view of these information asymmetries too. In this context, auditors serve as reputation agents as they are integral to validating the trust that principals place on their agents. It is within this framework that the agency theory helps to explain the development of audit by depicting agency relationships between principals and directors/managers. In this sense, auditors are crucial in their role as reputation agents as they provide an independent check on the work of agents and help to preempt or reduce the probability of conflicts that arise from divergent interests of principals and their agents, or report on such conflicts that may survive so that the principals are duly informed.

The associated issue is the validation of the auditing intermediary itself. How can investors trust the auditor to diligently discharge its duties and truthfully report back to the principals? This is where the auditor—acting as an appointed agent for this purpose—stakes its own reputation (and hence qualifies as an important reputation agent) for objectivity, integrity, and competence to do the tasks assigned to it. These are ensured by its professional training and education, experience, regulatory
discipline, and track record, as well as the skill sets and tools it employs in carrying out its assigned job without fear or favour, and the reputation associated with the professional institutes and their own processes, first to impart the necessary education and training to build necessary capacity, and thereafter to monitor and ensure that their members acquit themselves creditably on pain of disciplinary actions.

In light of a flurry of corporate scandals at the start of the twenty-first century, there have been ongoing demands for an improvement in audit quality globally. In 2003, the Council of International Federation of Accountants (IFAC) reviewed its governance activities and regulatory responsibilities, unanimously approving a set of reforms that were introduced to improve global audit quality. The objectives of these reforms were to strengthen the standard-setting processes of international audit, and to ensure that the international accountancy profession would also be sensitive to public interest. Claimed to be the most comprehensive in the history of IFAC’s initiatives, these reforms have been amply supported by international regulators. To this end, a Public Interest Oversight Board (PIOB) was established to oversee IFAC’s compliance and standard-setting activities with respect to audit, assurance, ethics, and independence. Likewise, the efforts to infuse greater transparency in audit and in the accountability of auditors in the UK are as a welcome change in this regard. In the UK (which follows a simple agency audit model), auditors are directly accountable to and owe a duty to a company’s existing shareholders as a body. The Audit Quality Forum has also been proactive in undertaking measures to strengthen shareholder involvement in the audit process.

In India, the Financial Reporting Review Board (FRRB) was constituted by the Institute of Chartered Accountants of India (ICAI) to review compliance with auditing and accounting standards, and to improve the overall quality of audit services. Even though the Quality Review Board (QRB) was set up additionally as an accounting oversight body in 2007, significant efforts to improve audit quality in India are few and far between as the QRB is neither completely independent nor fully operational—a concern elaborated upon later in this paper.
The orthodox and neoclassical framework of the principal-agent model is inadequate in explaining the successes and failures of the governance structures of certain types of businesses, such as family-owned businesses and/or owner-managed corporate entities, both of which are predominant in India and most Asian and European countries.

The stakeholder approach to corporate governance

While the value of the principal-agent model cannot be discounted, it has been challenged by a number of scholars and practitioners, and charged with defining the corporate purpose too narrowly as being shareholder wealth maximisation. A broader view would take into account the interests of a wider range of stakeholders (Freeman, 1984). The key stakeholders would vary from firm to firm in terms of their contribution and importance but generally a firm’s customers, vendors, financiers (including shareholders), employees and managers, the government, and the community are included as stakeholders. Given the varying levels of development and social awareness, different countries and regions (and indeed different industries and business segments) assume predominant claims on the corporation. Customers and employees have received substantial attention, as have environmental and societal issues in recent years.

In the stakeholder approach to corporate governance, a business entity (with its nexus of relations) must conduct its activities in a way that balances a variety of often non-congruent stakeholder interests. Companies increasingly view reputation agents as strategic partners as there is a perceptible link between corporate reputation and the reputation agents whom companies engage. Audited financials and audit opinions are the basis for vendor and customer relationships as well as employee negotiations and government assessments for tax and other purposes. Potential financial collaborators and funding agencies rely on the firm’s audited financials and credit rating agencies’ ratings as the bases for the assessment of their due diligence and creditworthiness respectively. The stock exchanges where a company’s securities are listed and the standards of regulatory design and enforcement discipline are useful
indicators for investors. The standing and reputation of these reputational agents therefore are a valuable and necessary input for a wide variety of a firm’s stakeholder community. It follows that stakeholders often perceive companies in a positive light if they are rated by reputed agencies, engage well-known auditors, are listed on respected stock exchanges, report sound control and risk management assurances, and are favourably portrayed by the country’s media.

3. Reputation agents in corporate governance

We now turn to a detailed consideration of select reputation agents and the nature, status, and potential of their role in upgrading the standards of corporate governance in the country.

Independent auditors

High-quality performance by independent accounting professionals benefits the economy and society by contributing towards the efficient allocation of financial resources and towards enhancing the efficiency of financial and capital markets (and through these, to the efficiency of production of goods and services). Independent auditors, with their certifications, help achieve a more informed and objective appreciation of the governance risks that investors and other stakeholders face with regard to specific corporate units.

Accounting and reporting are essential prerequisites of a strong financial infrastructure and a trusting investment climate, both of which are vital ingredients of success in economic growth and the expansion of business, trade, and investments. One of the core responsibilities of independent auditors is to provide assurance to shareholders and stakeholders regarding the true and fair nature of the information presented in their audit clients’ financial and other related statements. The importance of the audits of companies is uncontested. Capital markets could not function unless investors have some reasonable idea of the performance and financial position of the companies whose securities they buy and sell. Independent auditors serve as reputation agents because the public relies
heavily on their audit opinions to make investment decisions. The public perceives accounting firms to be independent and objective entities, free from the influence of their audit clients and other third parties.

High-quality financial reporting is critical to investor confidence. Financial reporting and corporate governance must both be supported by transparent and effective systems of monitoring and prudential enforcement. This is consistent with the principles of adopting international standards, regulatory coordination, transparency, and supporting open markets and investment that were agreed to at the G20 London Summit (2009).

The current scenario with respect to independent auditors is detailed below.

Audit of financial statements

Companies prepare and issue financial statements that reflect their performance over a (recent) period (typically a quarter or a year) and conform to a set of accounting principles that are generally accepted. The responsibility of preparing a company’s financial statements lies with the management. The role of an auditor is to express an opinion on those financial statements, and to plan and perform the audit to obtain reasonable assurance that these financial statements are free from material misstatement.

Chartered Accountants (CAs) in India function under the regulatory provisions and the Code of Ethics laid down by the Institute of Chartered Accountants of India (ICAI), founded by the Chartered Accountants Act (1949) to develop and regulate the profession of chartered accountants. The ICAI first undertook the task of setting the standards of accounting in India in 1977. However, the accounting standards issued by the ICAI were mandatory only for its members. The Companies (Amendment) Act (1999) mandated compliance with accounting standards in the preparation of accounts. The government prescribes these standards issued by ICAI in consultation with and as recommended by a National Advisory Committee on Accounting Standards (NACAS).
Promoting globally consistent standards for reporting and auditing

(1) Convergence with International Financial Reporting Standards (IFRS): Indian GAAP (generally accepted accounting principles) has evolved significantly over the last two decades leading to substantial improvements in financial reporting. While Indian standards are being modeled primarily on the basis of the IFRS, there are differences broadly in the areas of business combinations, consolidation, financial instruments, comparatives and presentation, to mention a few. Based on the recommendations of its study group, the ICAI has proposed full convergence with IFRS with effect from the accounting period commencing on or after 1 April 2011.

(2) Harmonisation with International Standards on Auditing: Indian auditing standards are largely based on the corresponding International Standards of Auditing (ISAs), with certain differences in the areas of quality control, analytical auditing, joint audits, reliance by a principal auditor on the work of the other auditor, etc. Auditing standards in India are formulated by the ICAI through its Auditing and Assurance Standards Board which has now embarked upon a programme of convergence with ISAs. This task presents several challenges, such as ensuring that relatively smaller firms also robustly fall in line.

The ICAI has issued a Standard on Quality Control (SQC) to offer guidance regarding a firm’s responsibilities for its system of quality control for audits and reviews of historical financial information and for other assurance and related engagements. The scope of professional misconduct in the ICAI’s Code of Ethics covers the following areas—failure to exercise due diligence; certifying and/or submitting reports without examining related records; failure to disclose any material fact(s) in a financial statement; failure to report a known material misstatement in a financial statement; failure to obtain sufficient information to express an opinion; failure to invite attention to any material departure from Indian GAAP; and bringing disrepute to the ICAI (even if the action does not relate to the profession).
Written representations

Written management representations are used to corroborate the validity of the premises that relate to management’s responsibilities and other forms of audit evidence obtained with regard to specific assertions in the financial statements. Such written representations provide necessary audit evidence of the validity of these premises. They are hence necessary to corroborate other forms audit evidence, particularly those where judgement, intent and/or completeness are involved.

Independence

IFAC has adopted a set of principles-based criteria to establish independence. In India, the ICAI’s Code of Ethics revolves around a set of professional ethical standards that regulate the relationship between CAs and their clients, employers, employees, fellow members of the ICAI, and the general public In addition to these standards, other regulators like the Reserve Bank of India (RBI) prescribe their own restrictions. The Companies Bill of 2009 introduces new independence measures and explicitly states that statutory auditors of companies must not render certain types of non-audit services due to potential conflicts of interest. Given the importance of independence to the audit process, multiple independence standards result in an overlap of enforcement regimes. Although there is a need for the effective enforcement of these standards, the universal adoption of a set of independence standards (perhaps those of the IFAC) would prevent complications associated with multiple definitions of independence.

Fraud detection

There is a significant “expectation gap” between what stakeholders believe auditors do in order to detect fraud and what audit networks are actually capable of doing. Prevailing auditing standards require auditors to conduct audits with a healthy degree of scepticism, always recognising the possibility that fraud could occur. The standards offer guidance on what auditors can do to uncover frauds that do exist. Given the inherent limitations in external audits, there is a limit to what auditors can reasonably
uncover. Given the time and resources constraints as well as the relatively low levels of audit fees, auditors tend to use indirect means to ascertain whether frauds have occurred, such as examinations of accounts and records with the main aim of looking out for anomalies, interactions with company employees and managements that are not under oath, as well as reviews of a company’s internal controls.

While these methods are clearly useful and essential in reasonably preventing and discovering frauds, they are not and cannot be foolproof. Hence the expectation gap arises because many investors, policymakers and the media erroneously believe that the auditors’ main function is to detect fraud, and are often erroneously presumed to be at fault if they failed to spot one that is discovered later.

**Rotation**

Only a handful of countries (notably the USA, Indonesia, India, Italy, Poland, Saudi Arabia, and Singapore) currently require some form of audit firm rotation after a predefined period. Of all the G20 economies, only Italy has mandatory firm rotation on a continuing basis. The IFAC’s Code of Ethics mandates the rotation of the lead audit partner once every seven years to safeguard the firm against over-familiarity. The ICAI’s SQC requires audit partner rotation for listed companies not later than a pre-defined period of seven years. The voluntary corporate governance guidelines recently provided by the Ministry of Corporate Affairs (MCA) suggest rotating the audit partner once in three years and the audit firm once in five years, to maintain the independence of auditors.

**Joint audits**

France has a tradition of joint auditors (of all the G20 nations). While Denmark had a system of mandatory joint audits earlier, it was abandoned in 2005. There are significant disadvantages associated with conducting joint audits. These involve increased costs to companies, a reduction of competition for non-audit services, blurred responsibilities, a decline in quality, and the danger of unlevelled field vis-à-vis international counterparts.
Next, we consider some key improvement levers for improving audit quality.

**Quality control**

ICAI has issued the Standard on Quality Control (SQC)-1 which applies to audits and other assurance related services engagements. The purpose of the SQC is to establish standards and provide guidance regarding a firm’s responsibilities for its system of quality control for audits and reviews of historical financial information, and for other assurance and related services engagements. It requires the firm to establish a system of quality control designed to provide it with reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements, and that reports issued by the firm or engagement partner are appropriate in the circumstances.

The firm’s system of quality control includes policies and procedures addressing leadership responsibilities for quality within the firm; ethical requirements; acceptance and continuance of client relationships and specific engagements; human resources; engagement performance; and monitoring.

The audit firm should share the quality control document with at least the listed company clients at the time of appointment, and it should be updated periodically to reflect the changes in the policies and procedures of the firm. This would assist in achieving transparency about the operations of the firm with the significant stakeholders.

**Written representations**

Written representations do not by themselves constitute sufficient/appropriate audit evidence of the validity of these premises. Furthermore, independent auditors are not relieved of their responsibilities to obtain other forms of audit evidence related to management representations. A strong peer review mechanism is desirable to help auditors comply with their responsibilities.

The audit committee should institute the practice of reviewing the company’s letter of representation to assess whether the representations
obtained are reasonable and valid in the context of the audit procedures performed and whether there are any areas where the auditors have unduly or excessively relied on management representations.

The other areas that require improvement include fraud detection, regular forensic audit, freedom of choice in auditor selection, rotation, etc.

What is sorely needed is a constructive dialogue between investors, stakeholders, policymakers and auditors, on the efforts that should be initiated to bridge the ‘expectation gap’ relating to fraud. However, this dialogue must recognise that the auditing profession is committed to continuously improving its abilities and methods to detect fraud. This is being done through the commitment of resources to support research into new methodologies and technologies that will expand the ability of an auditor to detect fraud.

The most aggressive (and also costly and intrusive) way of rooting out fraud involves mandating all public companies to undergo a forensic audit at least once every two to three years. Unlike the indirect means used to detect frauds in a conventional audit, a forensic audit resembles a police investigation. Forensic auditors scrutinise all records of the company (including emails), and question employees under oath. It might be necessary for an audit network or a specialised forensic auditor to perform a forensic audit with the aid of independent lawyers who have not represented the audit client during the period under review.

A less expensive version of the forensic audit idea would be to subject a sample of Indian listed companies to a forensic audit on a random basis. Although such a system might uncover fewer frauds, the deterrent effect could still be powerful because listed companies would know that they could be subject to forensic scrutiny at any time.

Regardless of whether our policymakers choose to mandate forensic audits on any basis, it is possible to close the ‘expectation gap’ by introducing more choices with regard to the intensity of audits. Since forensic audits are conducted primarily for the benefit of investors, one possibility would
be to let shareholders decide the intensity of the fraud detection effort they would like their auditors to perform. A different choice model would be one that allows boards or audit committees (as elected representatives of shareholders) to decide the level of fraud detection intensity. A key advantage of allowing investors or the board or the audit committee to choose the fraud detection level is that it would dispense with a ‘one-size-fits-all’ approach to fraud detection, instead encouraging a model that is tailored by the investors’ perceptions of the company.

In addition, the possibility that the relevant decision-makers might vote at any time to conduct a forensic audit could act as a powerful fraud deterrent to the management and its employees.

The 2006 amendments to the Chartered Accountants Act resulted in the setting up of a Quality Review Board (QRB) entrusted with the task of reviewing the quality of services (particularly audit services) by statutory auditors in India. The functions of the QRB include making recommendations to the Council for quality of services; reviewing the quality of services (including audit services); and guiding members to improve the quality of services and adherence to the various statutory and other regulatory requirements.

The Council of the ICAI has implemented a Peer Review from 1 April 2003 directed at the attestation services of the firms registered with it. As and when QRB becomes operational, it would be expected to manage the peer review mechanism.

It is unclear whether the QRB would only make recommendations with regard to quality of audit services or whether it would have ultimate powers on inspection and discipline. It is also unclear if it will have a majority of non-practising members—a prerequisite for recognition as equivalent by the EU or the PCAOB for home country reliance. Accordingly, appropriate independent regulatory oversight in India should be implemented to avoid unnecessary duplicative costs and potential conflicts of law. Further, public confidence is best served by external independent review of audit firms and selected audits. The lack of such reviews is a significant weakness in the operation of Indian capital markets.
The current situation in India is replete with artificial restrictions on the number of audit clients of a firm. The Indian Companies Act does not specify a limit on the statutory audits of private companies. However, the ICAI has capped the permissible number of statutory audits (including private companies) per partner to 30 (which is called a “self-regulatory measure”). Audit firm rotation rules are applicable for Indian banks (every four years) and audit firms are restricted to auditing no more than four private banks by the RBI. The Indian insurance regulator, IRDA, has laid down a maximum of two statutory insurance company audits per firm in addition to firm rotation. Given the specialist expertise needed for effective banking and insurance audits (in addition to the resources and skills required to carry out these large engagements), the restrictions represent a significant risk to audit quality. Companies should be able to choose an audit firm which is best able to serve them and their stakeholders without the impediment of these artificial restrictions. Despite support from Indian corporate entities, there has been no change to these arbitrary restrictions.

The appearance of independence in the audit function is important. However, comprehensive knowledge of the nature of the organisation’s business is critical to audit quality. Some observers and regulators from the accounting profession in India have suggested that the independence of audit firms and the effectiveness of audits would improve only if mandatory audit firm rotation were introduced. And the choice regarding whether or not to have joint audits should be left to audit committees and shareholders, and should not be mandated by regulation.

Regulators

The framework for regulatory compliance and the processes of oversight that regulators have in place are fundamental in the context of achieving good standards of governance at a macro level. For regulators to be more effective as reputational agents, it is essential for them to implement a strong institutional framework to monitor oversight and enforce compliance, engage in dialogue, share good practices, and encourage institutional activism.
A key objective of regulation in a corporate governance context is the protection of investors in general, as well as absentee shareholders and shareholders who are not in operational control in particular. Shareholder interests are safeguarded through mandates that promote fair play, transparency, and disclosure.

Regulators who issue detailed corporate governance guidelines to companies should periodically assess whether the regulations lead to holistic improvements in corporate governance practices and whether companies actually benefit in terms of improved performance, compliance with regulations and effective management of risks. The recent financial crisis led to intense debates on the adequacy of current corporate governance regulations in India and elsewhere. The role of regulators is particularly critical in this context.

Many regulators across the globe have adopted a ‘one-size-fits-all’ approach to corporate governance. The problem with this approach lies in its granularity and a compulsion to carry out the same set of actions in dissimilar situations. This often results in a box-ticking approach to governance and the underlying spirit of the regulations gets sidelined. In the context of corporate governance, regulators can enhance their reputation with stakeholders and thereby improve the overall standards of governance by essentially focusing on the adequacy of existing regulations; current practices in monitoring and regulatory oversight; and the role of institutions in promoting institutional activism.

Current scenario

Governance regulations and codes around the world have been either principles-based or rules-based. The regulatory system in the US is based on strictly enforced rules. In contrast, the UK adopts a principles-based governance model on a ‘comply-or-explain’ approach, where it is not necessary for companies to comply with all aspects of the code so long as they satisfactorily explain the justifications for their non-compliance. In response to the financial crisis, regulators around the world have responded by introducing a fresh wave of regulations.
Whether corporate India, which follows a rules-based governance structure, is complying with regulation merely in letter is a question that is often raised. This is particularly significant as the nature of corporate India’s approach to compliance and regulation exerts a sizeable influence on the quality of compliance. While a vast majority of Indian listed companies comply with Clause 49 of SEBI’s listing agreement, whether the quality of corporate governance is acceptable or not is a matter of debate.

In the ambit of Clause 49, corporate governance requirements fall broadly under two categories—mandatory and non-mandatory. Unlike governance codes elsewhere, it is not mandatory in India to put in place whistle-blower policies, board evaluations, nomination committees, and remuneration committees. However, these provisions are vital to protect the interests of non-promoter groups. Fortunately, the trend today is encouraging because sincere regulatory efforts are being initiated to supplement existing rules with broad-based governance principles. While there is no documented evidence suggesting principles-based governance as a mechanism mitigates financial crises and unforeseen contingencies in every respect, there is a strong case to contend that principles-based governance has a crucial role to play in boosting organisational performance. Further, a principles-based approach to governance promotes substantive equality, reduces arbitrariness, and helps companies adapt to an evolving environment Ford (2008, p. 7).

Corporate governance standards in promoter-driven, family-managed businesses remain a concern for institutional investors. The Ministry of Corporate Affairs has played a significant role in taking concrete steps to improve the corporate governance standards in India Inc through a two-pronged approach—strengthening the corporate governance provisions within the Companies Bill 2009 (proposed) through greater transparency in disclosures and enhanced powers to shareholders; and introducing the voluntary guidelines on corporate governance based on best practices that listed entities are encouraged to adopt. Although voluntary, companies are expected to adopt the guidelines using a “comply or explain” approach which implies that companies are expected to transparently disclose the
extent to which they have implemented the guidelines and the reasons for
non-adoption of certain guidelines.

*Key improvement levers for better regulatory oversight*

Regulators would become more mature in their role as reputation
agents if they seek out and internalise key insights from international
experience on how companies that pursue various corporate governance
prescriptions perform as against their peers who adopt a more principles-
driven approach. What India needs desperately is to strengthen regulatory
oversight. Four key areas of improvement have been identified to strengthen
regulatory oversight—monitoring the quality of disclosures; oversight of
audit quality; monitoring the implementation of corporate governance
norms; and cultivating the trend of regulators’ dialogues with institutions.

(1) Monitoring quality of disclosures: In India, SEBI’s monitoring of
disclosure requirements could be far more effective if it were to establish
an exclusive regulatory agency to monitor the consistency of company
disclosures, like the Financial Reporting Council (FRC) and the Financial
Reporting Review Panel (FRRP) do in the UK. The regulatory methodology
currently adopted can become increasingly valuable if SEBI ties up with
independent monitoring agencies that discharge their regulatory oversight
responsibilities, freeing SEBI to focus on the strategic components of
corporate governance regulation.

(2) Oversight of audit quality: To cover the audits of listed companies
incorporated in the UK, the FRC has constituted an Audit Inspection Unit
(AIU) as a part of the Professional Oversight Board, which supports
the FRC’s objective of investor and public confidence in the financial
governance of business organisations. The rationale behind the FRC’s
regulatory approach lies in facilitating strong connections between
the issues of corporate governance, audit, actuarial practice, corporate
reporting and professionalism of accountants and actuaries. This would be
a good model for India to adopt.

(3) Monitoring implementation of corporate governance norms:
Regulators have a crucial role to play in terms of monitoring how companies
implement the corporate governance norms in spirit. To be effective in their roles, and also in the context of enhancing their reputation with stakeholders, it is vital that regulators take proactive measures to identify corporate wrongdoing and identify instances of non-compliance that need to be dealt with firmly. There are several important prerequisites for achieving this objective—provisions within the legal system to penalise wrongdoers, including the severity of penalties; flexibility within the legal system to facilitate and enforce swift action; the extent of coordination between multiple agencies (e.g. SEBI, stock exchanges, and financial reporting oversight bodies such as the QRB); and the extent of dialogue between institutions and the regulators.

In comparison to some of the developed markets (notably the USA and the UK), India lags behind on each of these four aspects. In a corporate governance poll undertaken by KPMG in 2009, a vast majority of the poll respondents indicated that the quality of regulatory oversight in India is a much bigger issue than the adequacy of regulations. Despite the presence of stringent insider trading rules that date back to 1992, India has had very few instances of prosecution for insider trading. In recent times, we have seen non-compliances with Clause 49 of the SEBI listing agreement by several large listed Public Sector Units, yet neither the market regulator nor the government has come up with stringent sanctions, much to the detriment of stakeholders.

(4) Regulators’ dialogue with institutions: There is an urgent need in India to cultivate and develop institutions that can play the multiple roles of industry watchdogs, undertakers of governance research aimed at disseminating good practices, and institutional activists in the context of protecting the interests of retail investors. In the US, bodies such as the Council of Institutional Investors, the Millstein Center of Corporate Governance (a part of the Yale School of Business), the Director’s Institute, and the National Association of Corporate Directors (NACD) have been playing a critical role by introducing much needed changes to governance practices.
What could benefit India is a mechanism where regulators actively engage with industry bodies, professional and academic institutions, governance research centres as well as governance practitioners like independent directors, shaping the future of governance regulations and good practices.

It is desirable for SEBI and the stock exchanges to engage in an active dialogue with institutional investors, ensuring that their concerns and viewpoints are reflected in the way the amendments are made to future corporate governance codes. This would instil confidence in institutional investors on the role of Indian market regulators, resulting in a culture where governance requirements would be taken more seriously. A strong culture of shareholder activism would also result in industry adopting best practices voluntarily.

**Internal auditors**

The role of internal audit is evolving to focus on value creation instead of mere value preservation. Today, internal audit is required to meet the expectations of audit committees and to proactively help CEOs and CFOs to improve business processes, and to tackle emerging risks. A sharp line of distinction can be drawn between the role of internal auditors and that of independent auditors on the basis of the broad and crucial responsibilities that internal auditors are entrusted with, i.e. to support company boards and management in their risk management and strategy implementation efforts. Internal auditors are required to be independent and positioned appropriately to address the needs of multiple stakeholders.

*The importance of internal auditors as reputation agents*

The key role of internal audit lies in discharging its governance responsibilities by delivering a review of the organisation’s culture and adherence to its code of ethics; an objective evaluation of the existing risk assessment and management processes; systematic evaluations of business processes, associated controls, and their linkages to risk areas; review of the existence and valuation of assets; source of information on major frauds and irregularities, including periodic assessment of fraud
risks; review of regulatory compliance; and special and ad hoc reviews in new emerging risk areas or specific concerns flagged by the board and senior management.

Internal auditors have a moral duty to companies, their boards and shareholders. The business problems that they are instrumental in identifying can potentially generate adverse media coverage if they become public. The effects of such adverse coverage can result in fines, penalties, unbudgeted expenses, and unsolicited scrutiny—developments that can seriously damage an organisation’s reputation. Today, corporate boards are increasingly turning to the internal audit function to partner in their oversight efforts. CEOs and CFOs expect their internal auditors to move from a controls-and-compliance-centric approach to one that is risk-centric.

Current scenario

The unique focus of internal auditors on risks and controls is vital to good governance and financial reporting processes within organisations. Independent auditors provided no qualifications in the annual financial statements of over half of the 673 US public corporations that faced catastrophic bankruptcies since 1996 (Rosenfield, 2008). The organisations that succumbed to the largest bankruptcies (including Enron, Global Crossing, and Kmart) produced annual reports with clean audit opinions from their independent auditors. This demonstrates the increasing level of difficulty that independent auditors, boards, and managements face in developing an accurate picture of organisational risks and controls. It also draws attention to the vital role that internal auditors could play in shaping governance processes by assessing the effectiveness of organisational risk management regimes and apprising the board, senior management and external auditors of the risks and control issues that an organisation faces. In this context, a growing trend is for large corporations to supplement their in-house internal audit functions with co-sourcing arrangements whereby specialist external resources are used to review specific risks (Cashell, 2003). A survey conducted jointly by KPMG and the Bombay
Stock Exchange in 2009 highlighted several challenges for the internal audit function (KPMG, 2009).

**Key improvement levers**

The expansion in the scope of internal audit from a focus on conventional checks and balances to an overview of diverse functions that span process improvements, cost optimisation, a risk-based approach and revenue assurance through the identification of revenue leakages, will go a long way to enhance corporate value. A number of improvements are essential to achieve this transformation.

1. Positioning and independence of internal audit: Since its status within an organisation determines its effectiveness as a reputation agent, internal audit should be strategically positioned within the business to enable it to contribute to business performance. The role of internal audit has evolved as a major risk management tool to involve much more than just checking numbers and vouching invoices.

   Independence and objectivity are critical components of an effective internal audit function. The independence of internal audit is a prerequisite to tackle governance failures and to tackle the tendency of owners and managers to override internal controls. Moreover, internal auditors must maintain a high level of objectivity by ensuring they have no vested interest in the areas they are auditing. In addition to such professionalism, it is important to operate with an unbiased and impartial mind. In this regard, it is important to raise the profile of internal audit in an organisation.

   Audit committees need to be more involved in all operational aspects that encompass the coverage, skill-sets, appointment processes, remuneration, and performance of internal audit (Braiotta, 2002).

   It is important for the Chief Audit Executive (CAE) to be treated on par with other senior executive positions and to have a say in matters of strategy, risk and regulatory compliance. More importantly, the CAE should have the freedom to question any level of management about their activities and compliance with organisational policies and risk thresholds.
To achieve this, the CAE should have direct access to the CEO and audit committee.

The internal audit charter should establish the independence of the internal auditor by calling for a dual reporting relationship to the management and the audit committee. The reports to the executive management are useful when assistance is required to establish direction, support and an administrative interface. Such a reporting structure would help the audit committee in its strategic direction and accountability. Further, internal auditors should have unfettered access to records and personnel as and when these are deemed to be necessary for their audits. They must also be allowed to use appropriate probing techniques without impediment.

Direct channels of communication between the CAE and the audit committee reinforce the organisational status of internal audit and facilitate access to organisational resources while ensuring independence is not impaired. This approach provides sufficient authority to achieve broad audit coverage and adequate consideration of engagement communications. Independence is further enhanced if the CAE reports to the board through the audit committee on the planning, execution and results of audit activities. The audit committee should be responsible for appointing, removing and fixing the CAE’s compensation. The audit committee should also safeguard the internal auditor’s independence by periodically approving the internal audit charter and mandate.

(2) Skill-sets of internal auditors: Internal auditors must move away from a traditional audit approach to one that is centred on a risk-based annual audit plan, and is constantly updated based on the changing risk profile and stakeholder expectations, and operates within the contours of a nimble and flexible scheduling and planning model.

In view of the impact of globalisation, technological advancement, and risk management changes, there is the added challenge of re-tooling internal audit skill-sets to include people with experience and skills in the use of data mining and analytical tools as well as people with specific
talents given the myriad of risks highlighted above. Internal auditors should be increasingly using technology-driven tools to transform traditional approaches when they conduct audits.

It is also critical to adopt “continuous auditing techniques” as greater assurance can be provided more quickly at substantially lower cost. Today’s boards and audit committees are looking at real-time assurance based on the coverage of large volumes of data, rather than small sample sizes. The use of continuous auditing and monitoring tools is therefore essential if internal auditors are to be more effective in providing real-time assurance.

(3) Performance and accountability of internal auditors: Of the many factors that have surfaced as causes of weak governance structures in India, the lack of accountability of the internal audit profession, along with poor internal auditing standards, have emerged as the more controversial ones. To maintain accountability, it is important to establish objectivity in the course of any internal audit engagement.

In this context, KPMG’s 2009 Internal Audit survey highlighted that only 31% of all Indian organisations were undertaking a focused performance evaluation of their internal audit function. Most internal auditors in Indian listed companies do not seek feedback from their key stakeholders either after completing their internal audits or before issuing internal audit reports. Hence most Indian companies lack an effective framework to assess how they are delivering internal audit engagements, and also whether the intended assurance objectives are being met.

From a broader reputation perspective, disclosure aspects related to internal audits should be revisited. Presently, the Companies Act 1956 requires statutory auditors to report whether companies have an internal audit function that is adequate in the context of the business and commensurate with the size of business operations. However disclosures in the Auditor’s Reports are vague and do not provide stakeholders an objective view of the robustness of the internal audit function. Global governance failures have time and again led to a flurry of questions in
connection with the role of external auditors, their scope of audit and the quality of their disclosures in audit reports. A similar scrutiny of the internal auditors would prove worthwhile.

**Rating agencies**

Rating agencies are reputation agents because many investors base their decisions on the agencies’ certifications and assurances with regard to rated securities, and also the way they rate other corporate practices.

*The importance of rating agencies as reputation agents*

A rating agency is required to publicly disclose the percentage of net revenues attributable to the largest users of credit rating services and also the percentage of net revenues (of the rating agency) that are attributable to other related products and services of the agency. On the global front, credit ratings have evolved in their role as reputation agents over the years, more recently gaining acceptance as convenient tools for differentiating credit quality (Standard & Poor’s, 2002). Globalisation and the advent of Basel II (which incorporated ratings into rules for setting weights for credit risk) gave credit rating agencies a further boost (Elkhoury, 2008).

The role of credit rating agencies in India has grown phenomenally in view of the expansion in the volume of issuance. Another encouraging trend is the increasing level of reliance that investors and regulators have begun to place on the ratings provided by these agencies. In recent times, the role of credit rating agencies as reputation agents is also gradually becoming more interrelated with the roles of regulators and internal auditors because credit rating agencies have begun playing a more instrumental role in helping achieve the regulatory objectives of investor protection, transparency in markets, and the mitigation of the occurrence and/or impact of systemic risks.

*Current scenario*

Credit ratings in India have been operational for over two decades. CRISIL (Credit Rating and Information Services of India Limited) was the first rating agency that was set up. India presently has five registered
rating agencies—CRISIL, CARE (Credit Research Analyst Ltd), ICRA (Investment Information and Credit Rating Agency), Fitch, and Brickwork Ratings India.

SEBI’s regulations (1999) provide various guidelines with regard to the modus operandi for the registration and functioning of credit rating agencies in India. The registration procedure includes a strict examination of the details provided by rating agencies in their application for the establishment of their agencies in India. Credit rating agencies are also provided with compliance officers to whom they are required to share their accounting records (SEBI, 1999). In the ambit of the Indian regulatory framework, credit rating agencies are required to abide by the Code of Conduct contained in the Third Schedule.

As per SEBI’s guidelines, the requirements that rating agencies in India, are to (1) continuously monitor the ratings of their securities; (2) frame appropriate systems and procedures to monitor the trading of securities; (3) share information on newly assigned ratings and/or changes in its earlier ratings, through press releases and websites; (4) supply information on new rating developments, to the regional stock exchanges that a rating agency operate in and all other stock exchanges where there securities are listed (in the case of securities that are issued by listed companies in India); and (5) conduct periodic reviews of published ratings during the lifetime of the securities that have been rated.

In January 2010, SEBI mandated that credit rating agencies should have internal audits, to be conducted on a half-yearly basis, covering all aspects of credit rating agency operations and procedures including investor grievance and redressal mechanisms. The key rationale behind this measure was the evaluation of the adequacy of systems adopted by credit rating agencies to comply with regulatory requirements, the rectification of existing deficiencies (if any), and the reduction of the incidence of violations observed.

Key improvement levers

More transparency is required for the accuracy of additional information on the magnitude of any existing or impending conflicts.
Secondly, the excessive process orientation of credit rating agencies worldwide tends to undermine their role as reputation agents. For instance, Standard & Poor’s (S&P) had committed to integrating enterprise risk management (ERM) into its rating process for non-financial corporations. S&P, which views ERM as a tool to assess management, expects to complete its ERM criteria with a view to including an analysis of ERM structures in its overall ratings of non-financial entities. S&P hopes that the inclusion of ERM factors into its credit analyses will improve the overall quality of ratings by enhancing its opinions on the management of corporate borrowers (Aon Global Risk Consulting, 2009). Seeking to revise its rating process in 2009, S&P ran into delays as the result of the financial crisis and an impending need to complete a series of additional in-depth interviews with companies on the theme of their ERM capabilities.

However, one of the pitfalls associated with S&P’s approach is the complexity of the process. Having met with the CFOs of the companies they interviewed, rating analysts found that ERM responsibilities may lie elsewhere and not with CFOs or treasurers. S&P has presently undertaken about 300 ERM interviews with non-financial companies. However, this number represents only 10% of the companies that are otherwise rated by S&P (Towers Perrin, 2009). This sample is too small to publish any formal criteria. On such occasions, transparency and external validation of new criteria do not suffice. It is essential to have strong internal acceptance of new criteria within rating agencies too. In this context, it is the degree of comprehensiveness in the approach adopted by rating agencies to publish their statements or fine-tune their oversight capabilities that would strengthen their role as reputation agents.

A more valuable way of benchmarking companies would involve framing clear yardsticks for different rating parameters and evaluating companies on the basis of these benchmarks for each rating parameter. Since ratings are integral to a company’s reputation, this approach will most likely sharpen the focus of companies on their own internal benchmarking practices, performance and reputation management efforts.
The Role of Reputation Agents in Corporate Governance

The media

The media is instrumental in influencing and mobilising public opinion and market perceptions of the performance and corporate affairs of organisations. While it is vital for Indian listed companies to develop and maintain effective and sustainable relations with the media, both in India and abroad, the advent of social networking sites and the shift in power from media producers to media consumers demonstrate the growing importance of the media as reputation agents. A classic example of the impact of the media on corporate reputation is the ability of public critics to broadcast their complaints and opinions of companies and their products and services around the world via the Internet.

The importance of media bodies as reputation agents

In this paper we will limit the definition of media to comprise corporate entities, publishers, journalists, and reporters who constitute the communications industry. The media is a powerful agent in disseminating public opinion and inducing a change in the mindsets of the public by altering their perceptions through representational communication modes. Such representational projections of corporate bodies and the brands associated with them have a direct impact on corporate reputation. The various sections of the media are crucial in their role as reputation agents as they serve as liaisons between organisations and their publics. Dyck et al. (2008) observe that the media serves an integral role specifically in absorbing the cost of gathering information (from companies) that would benefit shareholders.

The onus on the media to unravel corporate governance issues is large, especially in situations where regulatory mechanisms to protect investors are relatively weak.

Current scenario

The media can be extremely effective in its role as a reputation agent in view of its capacity to build an image of the culture and identity of a corporate entity behind the face of its brands, products, and services. However, the role of the media is typically influenced by the corporate
communications efforts that organisations initiate. Today corporate communications has become an art of perception management. The focus of corporate communication professionals has been extended to include the need to develop a strong base of reputation capital and build positive relationships with the media. The drawback associated with the creation and sustenance of a strong relationship between corporate communication/PR professionals and the media is that there is a possibility of the existing and/or impending corporate governance glitches and accounting shenanigans being overlooked by the media or bring reported mildly, until these grow to such an extent that they impact the economy and/or become world news.

In India, corporate governance issues appear at the forefront of media reports and broadcasts only after the occurrence of a major governance scandal. The obsessive focus of the print and electronic media on the quarterly earnings of Indian listed companies is another example that typifies the media’s one-dimensional focus on financial performance. Specifically in the context of corporate governance, the role of the media can at best be termed as reactive.

What exacerbates this state of affairs is the relatively poor media regulatory framework in India. When compared with the UK and the US communications regulatory structures (which are strong and well-defined, even while being different from one another), the media governance standards in India are inadequate. The Office of Communications (Ofcom) in the UK ensures that media consumers get satisfaction from the media and communications services that they are provided. The communications regulator also protects individuals and companies from privacy intrusions, scams and fraudulent practices while simultaneously encouraging competition. While Ofcom regulates the television, telecom and mobile convergence sectors, the Press Complaints Commission (PCC) serves as an independent self-regulatory body to deal with complaints and disputes about the editorial content of newspapers and magazines and their websites. The PCC also trains journalists and editors, working proactively to prevent media intrusion and falsified media reports. Additionally, pre-publication advice is provided to journalists as well as the public.
The US communications industry is monitored by the Federal Communications Commission (FCC), which regulates interstate and international communications via television, radio, wire, and satellite. The FCC handles a wide range of concerns ranging from consumer and governmental affairs to media issues.

In striking contrast, the closest full-fledged regulator that India has to monitor the communications industry (or rather a part of it) is the Telecom Regulatory Authority of India (TRAI). India does not have the equivalent of Ofcom or the FCC. Even while broadcast regulatory measures have been discussed by the Ministry of Information & Broadcasting, the urgency to initiate any action appears to be diluted by other more important predicaments on the Ministry’s agenda.

Key improvement levers

Companies should move beyond the contours of basic media monitoring, which is largely focused on merely calculating the number of significant mentions of a company and/or its related brands, products and services across varied media reports. It is recommended that companies devise a suitable mechanism to track the effectiveness of their campaigns, marketing efforts, and representations of their brands.

A greater degree of efficiency in the public relations efforts of companies is vital to facilitate direct communication with the media to ensure good governance and human rights.

In its capacity as a watchdog of accountability and transparency, the media must impartially disseminate news and create transparency in corporate entities.

The Indian media needs to have a more sustained form of reporting. It is important for business journalists and newscasters to discuss corporate governance and risk management issues as part of their regular discussion and reporting.

In analysing corporate performance, the media should also focus on other important aspects such as investor relations and communication
practices, the quality of corporate boards and companies’ adherence to environmental, labour and ethical standards (e.g. safety, sustainability and communities). Editorials have begun to publish comprehensive and insightful articles on corporate governance. However these continue to be few and far between. The subject of corporate governance can receive more prominence in the media if specialists and laymen simultaneously engage in stimulating debates on those issues of foremost significance to Indian listed companies—transparency, accountability, governance, and shareholder activism.

The Indian media needs to portray a balanced picture of current societal needs and the role of corporate bodies in catering to these needs. To this end, it is also essential to project companies on the basis of a triple bottom line approach that highlights the social, economic, and environmental contributions of companies instead of focusing merely on companies’ financial worth.

There is a need for self-regulatory provisions to propagate a culture of sustained media reporting/broadcasting and infuse balanced, responsible and more pluralistic journalism in India. An independent self-regulatory mechanism is necessary for the media to be effective and powerful in their role as reputation agents for Indian listed companies as well as the larger shareholder communities and members of the general public.

References


Notes

¹ The sections on regulators, rating agencies, and the media were developed from KPMG’s thought leadership publications and research reports.
A simple agency model of audit is a structure which is characterised by the introduction of an expert independent auditor and the execution of a statutory audit, which is intended to help address simple agency conflicts between a company’s shareholders and directors. See Institute of Chartered Accountants in England and Wales (2005, p. 9).

The earlier version of the ICAI’s Code of Ethics included only “gross negligence” under the purview of professional misdemeanour.

While rotating audit firms is useful in enhancing the independence of audits, it has its pitfalls too. For instance, it could erase the cumulative knowledge of an audit firm, and reduce audit effectiveness, and it increases business costs and reduces efficiency.

The standard was recommendatory for all engagements relating to accounting periods beginning on or after 1 April 2008, and became mandatory for all engagements relating to accounting periods beginning on or after 1 April 2009.

The current construct of the QRB is unlikely to meet the membership criteria of the International Federation of Independent Audit Regulators (IFIAR).

For more details, see Leadership Acumen (2004).

See The Economic Times Bureau (2010) for more details.

Ofcom is an independent communications watchdog, which operates under the Communications Act, 2003 in the UK to propagate media ethics and further the interests of the UK’s citizens and consumers. Incidentally, Ofcom is entirely independent from the Government.

Established by the Communications Act of 1934, the Federal Commission of Commission (FCC) is an independent United States Government communication agency. The FCC’s jurisdiction covers 50 states, the District of Columbia and the U.S. possession. Though a Government agency, it retains its independence in every sense.