

Audit of Public Enterprises: Three Phased Audit and Other Initiatives

K.P. Sasidharan

The pervasive weaknesses in financial industry regulation and global financial system have triggered the sub prime crisis, precipitating the ongoing financial predicament, leading to global melt down. The current financial crisis combined with series of corporate governance failures internationally and in the country including recent Satyam fiasco in India has catapulted the issue of corporate governance at the central stage of the governance framework along with the role of independent directors, audit committee, auditors and regulators. In ensuring good corporate governance practices in the public sector enterprises, the regulators like the Ministry of Corporate Affairs, the Institute of Chartered Accountants of India, the Securities and Exchange of Board of India, the Reserve Bank of India, and the Comptroller and Auditor General of India (C&AG) have specific individual as well as collective coordinating roles.

This article highlights the process of audit of accounts of PSEs and primarily focuses on how the CAG of India as a regulator has responded to some of the challenges emerging from recent corporate governance failures in addressing issues and concerns relating to audit of public sector enterprises. Before elucidating some of the innovative measures taken by the CAG of India recently to keep abreast with the changing financial scenario as well as maintaining independence of auditors, an attempt has been made to appreciate the efforts of the C&AG in the right perspective countering some of the criticisms against the financial attestation functions of PSEs by the supreme audit institution of India. The article also emphasises the need for collective coordinative action to be taken by the regulators while clamouring for more and more regulatory authorities including regulators of regulators, auditor of auditors and national oversight body to avert governance failure and bring better credibility to the financial reporting and auditing system in the public sector enterprises.

Role of the C&AG in Audit of PSEs

As per the provisions of the Companies Act, 1956 read with Section 19 of the 'Comptroller and Auditor General's (Duties, Powers and Conditions of Service) Act, 1971' and the C&AG's Regulations 2007¹, the C&AG is vested with audit of the financial statements² of all the Government companies. In order to discharge this responsibility, he is empowered to appoint the auditors as well as issue directions to the

1 Chapter 9 of the C&AG's Regulations on Audit and Accounts 2007

2 It includes Balance Sheet, Profit & Loss Account/Income & Expenditure Account and, wherever applicable, Cash Flow Statement.

auditors specifying the manner in which the accounts of government companies are to be audited under Section 619(2) and (3) of the Companies Act, 1956, keeping in view his overall responsibility of ensuring public accountability. As the Supreme Audit Institution of the country, the C&AG plays an oversight role ensuring that the statutory auditors discharge their assigned responsibilities with due diligence on his behalf by exercising the power to supplement or comment upon the statutory auditors' report under Section 619(4) of the Act.

Besides financial audit, the C&AG is also mandated to conduct performance audit and compliance audit of the government companies. Performance audit is an independent assessment or evaluation of an entity's programme or activity with reference to the laid down goals, objectives and targets, taking into account relevant criteria for assessment of efficiency, economy and effectiveness of operations. This is done mainly through the Audit Board mechanism, chaired by the Deputy Comptroller and Auditor General (Commercial), with senior officers of the C&AG and two technical experts inducted as special invitees, if necessary. The main objective of 'performance audit' is to assist the people's representatives in exercising effective legislative control and oversight over the policy objectives and their implementation. The elaborate process of performance audit involves understanding the activities of the organisation, risk assessment, systems and controls, and brings out systemic deficiencies, absence of controls or their ineffective functioning and compliance failures. The Audit probe goes into the root causes of the problems and suggests constructive recommendations to the executives for improvement. In Compliance Audit, the C&AG examines the transactions relating to receipts and expenditure, assets and liabilities of government companies and corporations to ensure compliance with all applicable laws, rules and regulations and procedures.

By conducting audit of PSEs by three frameworks of audit viz. financial audit, performance audit and compliance audit, which are interlinked and complementary to one another, C&AG prepares three distinct audit reports on the functioning of the PSEs, commenting upon their state of financial affairs, operational efficiency, governance and compliance issues. These reports are placed in the Parliament and the selected reports are discussed comprehensively by COPU recommending remedial measures for improvement.

The Audit Process in PSEs

The entire gamut of financial attestation functions of the C&AG encompasses appointment of Auditors by CAG, issuing directions to them, preparation of financial statements by the management, audit thereof by the statutory auditors and supplementary audit by C&AG as detailed below:

(i) Appointment of Auditors: Registration, Empanelment and Allocation of Audit

Ensuring expected quality in financial attestation functions of PSEs has all along been a challenging task. In order to ensure quality of audit, it is imperative that competent, capable and upright audit firms are selected for an assignment taking into account its complexity, magnitude of operations and volume of transactions. The powers to appoint

the statutory auditors of the Government companies are, therefore, conferred to the C&AG vide Section 619(2) of the 'Companies Act, 1956' as amended in 2000.

In order to select the competent auditors, the basic eligibility criteria for empanelment for PSE audit are determined in consultation with the Institute of Chartered Accountants (ICAI) that the firm should be registered with ICAI and should have at least one full time FCA member on the date of registration. Applications are invited from eligible CA firms from four regions of the country north, south, east and west every year from 1st January to 15th February using an on line web based application format made available in the internet. The input format is developed by the National Informatics Centre and is further updated every year before registration based on the policy changes adopted normally in consultation with the ICAI to keep it abreast with the changing requirements. The data received from the CA firms located across the length and breadth of the country are further cross checked with documents submitted by post by them and more importantly tallied with the data provided by ICAI containing particulars of the firms indicating status, location of head office and branches, partners, employees, their qualifications, experience, association with the firm, income etc. and thus the panel of eligible audit firms is updated in the beginning of every year before allocation of audits is undertaken.

The panel prepared is divided into two categories one for minor audits with a fee not exceeding rupees one lakh and fifty thousand and the other for major audits exceeding audit fee more than that. The criteria for qualifying as a major firm for taking bigger audit assignments is that the firm should have at least six full time CAs of which five should be partners and one can be an employee. The association of partners with the firm is specified as one partner should be with ten years or more, three partners with five years or more and rest of the two partners/CA employee with one year. The process of registration, empanelment, awarding points to firms registered on the basis of accepted criteria on a predetermined point system is computerised and the system is audited by an independent departmental committee of senior officers to ensure data integrity and authenticity. While major firms shortlisted based on the criteria specified are considered for available major audit jobs which range from 150 to 250 or so in a year by a high power departmental committee. The remaining firms in the panel including those firms qualified but could not obtain major audits due to lack of audit assignments are allotted audits by software programme which matches the firms with maximum points in a station with maximum audit fee available in that particular location. The empanelled auditors are much more than the available audits; for example, during the last three years ending March 2009, C&AG empanelled 5381, 6082 and 5084 CA firms, out of which 2786, 2661 and 2657 CA firms were allotted audit.

The credibility and brand equity of C&AG empanelment enhance opportunities of audit firms for being considered for varied audit assignments available with different ministries, departments and institutions of the central and state governments and urban local bodies including corporation, municipality, panchayat and other local organs of state administration. The computerised system of empanelment of auditors for PSE audit assignments has been evolved over the years and criteria and process have been continuously improved as per the emerging requirements. The transparency and objectivity of the system has been acknowledged and appreciated by ICAI, which comes out with suggestions for modifications every year as per professional needs, RBI who

uses the panel for appointment of statutory auditors for public sector banks, central government and state governments who call for empanelled auditors for considering for specified accounts and audit assignments including special audits, audit of World Bank aided projects, autonomous bodies and societies available from time to time

(ii) Initiatives taken to ensure independence of Statutory Auditors

The statutory auditors have a fiduciary duty to provide independent, professional opinion on the financial statements of the company audited by them. In order to ensure independence of the statutory auditors and to obviate any chances of conflict of interest, provisions exist in Section 226 of the 'Companies Act, 1956' disqualifying certain persons for appointment as auditor of a company. Similarly, the Chartered Accountants Act, 1949 also contains provisions to ensure independence of the statutory auditors. The Naresh Chandra Committee, constituted in 2002 by the Government of India for examining the auditor-company relationship made recommendations prohibiting the statutory auditors of the companies from taking certain assignments like internal audit, accounting and book keeping, actuarial services, management functions, valuation services, etc. and recommended rotation of auditors. These well acknowledged safeguards for ensuring independence of auditors have already been factored into allocation of audit assignments of PSEs by C&AG by appointing joint auditors for major PSEs and listed companies, rotating the auditors after a term of four years subject to case to case evaluation, firms' continuous empanelment during the period and their performance and also prohibition of certain non-audit assignments. In order to assess objectively the performance of the audit firms, well structured format with relevant information and parameters has been used and if the performance is found lacking, appropriate penal action is taken against the firm by the departmental disciplinary committee set up for the purpose. The statutory auditors are either cautioned or debarred for allotment of audit up to three years depending upon the nature and magnitude of professional negligence and misconduct.

(iii) Directions, Sub-directions, Additional-directions to the statutory auditors

Before commencement of audit, expectations from the auditors are spelt out explicitly by C&AG by issuing directions under Section 619(3) (a) of the Companies Act, 1956. These directions contain specific questionnaire to assess the quality of corporate governance, preparedness to meet business risks, status of disinvestment if applicable, operational efficiency and productivity, the system of accounts & financial control, possibilities of fraud, the status of assets, inventory, investments, liabilities and loans, award & execution of contracts, quality of the internal audit system, human resource development, status of legal arbitration cases, reliability of information technology and management information system, measures taken towards environment management and issues relating to Memorandum of Understanding and energy audit. Besides general directions under 619(3)(a), the Member Audit Board entrusted with audit of a particular PSE issues industry specific sub-directions to the statutory auditors and discusses the audit plan and related issues in detail in a tri-party meeting where government auditors, statutory auditors and management executives are present. In the current year, three phased audit system has been introduced in 80 odd CPSEs including listed companies, Navaratna, Miniratna, and corporations where C&AG is the sole auditor and during the course of the attestation audit, government audit issues additional directions specific to the CPSE under

audit for taking corrective action till the accounts are adopted and signed by the Board of Directors and before the Supplementary Audit under 619(4) is undertaken.

(iv) Preparation of Financial statements by the Management and Audit by Statutory Auditors

The preparation of financial statements in accordance with the financial reporting framework prescribed under the Companies Act, 1956 or other relevant Act (like IRDA, RBI) is the responsibility of the Management of the PSE. The Statutory Auditors appointed by the C&AG under section 619(2) of the Companies Act, 1956 are responsible for expressing an opinion on the financial statements under section 227 of the Companies Act, 1956 based on independent audit in accordance with the auditing and assurance standards prescribed by ICAI, the professional body and directions given by the C&AG. The statutory auditors are required to submit a copy of the audit report to the CAG under Section 619(4) of the Companies Act, 1956.

(v) Supplementary audit of financial statements by the CAG Auditors

The certified accounts along with report of the Statutory Auditors are reviewed by C&AG. On the basis of the review and predetermined parameters, a decision is taken whether to conduct supplementary audit under section 619 (3) (b) of the Companies Act, 1956 of the financial statements of a PSE. This supplementary audit carried out independently is limited primarily to the inquiries of the statutory auditors and Company personnel and a selective examination of some of the accounting records. Based on such a supplementary audit, significant audit observations, if any, are reported under section 619 (4) of the Companies Act, 1956 to be placed before the Annual General Meeting. The supplementary audit by C&AG also oversees any undue observations of auditors, if any, and provides a safeguard to the management of PSEs. The Annual reports of the CPSEs including financial statements are laid before both the houses of the Parliament. A gist of significant audit observations made on the accounts of CPSEs are compiled in C&AG' Audit Report and are laid on both the houses of the Parliament. The Committee of Public Sector Undertakings (COPU) discusses selected audit observations with the administrative ministry and the management of the concerned PSE and recommends appropriate corrective measures for improving the functioning of the PSE in question.

Ensuring Public Accountability by Oversight Audit of Financial Statements

While powers of the C&AG in conducting Compliance Audit and Performance Audit have been appreciated by and large, his powers to conduct Supplementary Audit of PSEs have been a subject matter of debate over the years. The Economic Administrative Reforms Commission (Jha Commission), in its report in 1983, favoured double audit of PSEs; first an audit by a firm of Chartered Accountants who are the statutory auditors of the PSE in question, followed by a Supplementary Audit by the C&AG. The Irani Committee set up by the Ministry of Corporate Affairs in 2005 and the Ad hoc Group of Experts (AGE) under the chairmanship of Dr. Arjun Sengupta constituted by the Department of Public Enterprises, opined that since audit of government companies is conducted by the statutory auditors appointed by the C&AG in the manner directed by him, the Supplementary Audit by the CAG is redundant, duplication of audit and

superfluous. More recently, in 2008, the Confederation of Indian Industry and Deloitte in a joint study report, "Autonomy with Accountability: Strengthening Public Sector Enterprises" also criticized the C&AG's supplementary audit functions as an impediment to functional autonomy. The recommendations of the Irani Committee and the Ad hoc Group of Experts on supplementary audit were not eventually accepted by the government like the earlier recommendations of the Jha Commission and Arjun Sengupta Committee.

The C&AG's oversight role is inherently more comprehensive, integrated and in depth than that of the audit responsibility of the statutory auditors appointed by him. As the auditor of PSEs, he conducts audit exercising all the three mandated frameworks of audit viz. compliance audit, financial audit and performance audit to get the totality of the functioning of the enterprises thereby ensuring public accountability and parliamentary control. The fundamental objective of audit of PSEs is to ensure public accountability by improving the quality of audit. Financial audit is an inevitable component of the audit process. The quality of financial statements and audit certificates of PSEs need to be kept at the expected level. While certifying the accounts and formulating an opinion on the financial health of an organization, the basic objective of improving the quality and readability of financial statements is to be kept in mind while taking an objective and balanced view of the conflicting interests of varied stakeholders.

The statutory auditor is appointed by C&AG and he functions on his behalf. It is his fiduciary responsibility to ensure that the statutory auditor does his job with due diligence complying with applicable statutes, rules and standards. As the overall responsibility is vested upon C&AG, it is important not only to guide, direct, monitor, oversee, review, supplement and complement the financial attestation functions of the statutory auditors but also safeguard the independence of auditors against unethical practices and conflicting demands from the management.

The system has withstood years of criticism, ensuring that fraudulent transactions, recurrent creative accounting and auditing irregularities of the type of Satyam and Global Trust Bank quite rampant in private sector companies are not occurring in the PSEs. Financial accountability is an inevitable element of good corporate governance. It was in this context that in 1956 the parliament and the government of the day prescribed supplementary audit of government companies by the C&AG. The C&AG is responsible for ensuring that public business is conducted in accordance with applicable law, rules and regulations apart from compliance with applicable accounting and auditing standards, and that public money is safeguarded, properly accounted for and utilized economically, efficiently and effectively.

The significance of C&AG's supplementary audit can be gauged from the fact that every year several PSEs revise their accounts after supplementary audit and comments are issued to number of PSEs. In 2006-07, twelve Central PSEs revised their accounts after supplementary audit and comments were issued in respect of 72 Central PSEs besides number of state government PSEs as well. The impact of supplementary audit of accounts of these Central PSEs for the year 2006-07 being the last Report placed in the Parliament was over/under-statement of profit/loss of the companies to the extent of Rs.1095.54 crore and over/understatement of assets and liabilities to the extent of Rs.94.89 crore.

Thus, instead of duplicating the work of the statutory auditor, supplementary audit adds value, credibility, ensures uniformity, consistency and objectivity in treatment of similar type of transactions in identical industrial sector as well as complements the initial audit conducted by the statutory auditor by providing an assurance to the Parliament through an independent authority, that public funds are being utilized in an economical, efficient and effective manner. The supplementary audit by the C&AG has deterrent effects on company's management and statutory auditor as well. As the comments are issued by the C&AG on the accounts, the management takes due care in preparation of accounts and puts its best efforts in presentation thereof in accordance with the applicable statutes, accounting standards and principles and also takes corrective actions. Further, that the arguments advocated against the audit by C&AG does not hold ground is evident from the decision of the government to retain the powers of supplementary audit by C&AG in the Company Amendment bill 2008.

Disturbing Research Findings on Fraud and Creative Accounting

According to World Bank report³ on observance of standards and codes-accounting and auditing, the Ministry of Corporate Affairs has the mandate to monitor general purpose financial reporting which is exercised primarily through statutory audits. SEBI does not proactively monitor compliance with Clause 49 of the Listing Agreement and financial reporting requirements. Bombay and National Stock Exchanges insist on external auditors to monitor compliance with the accounting and disclosure requirements.

In respect of private sector companies, the external auditors are selected by the management and are generally not rotated. Thus, the independence of the auditors becomes a debatable issue. A large number of listed companies in the private sector have been indulging in financial statement frauds. Cases of Global Trust bank and Satyam are most commonly known. Some of the studies conducted in India revealed that companies have been using techniques of creative accounting.

The joint research conducted by the ICAI and Indiaforensic on "Early Warning Signals of Corporate Frauds" in India revealed that 20-30 percent clients commit the financial statement frauds in India. The major categories of frauds related to cash, inventory, accounts payable, accounts receivable, payroll, and revenue recognition schemes. The major industrial sectors where frauds were identified include manufacturing including pharmaceuticals, real estate and construction, government and public administration, banks and Non Banking Financial Sector, insurance, oil and gas, services, transport and warehousing, media, IT companies etc. An analysis of 500 companies listed on Bombay Stock Exchange conducted by Noble bank revealed that companies resort to creative accounting at times of heightened economic stress characterised by economic slow down in GDP growth combined with profit margin pressure. Prevalent creative accounting practices of the BSE listed companies were identified as recording revenue ahead of time, booking fictitious sales, expense and cash manipulations, invisible restatements of prior periods. The research findings are briefly the following:

- at least 30 companies had been using aggressive revenue recognition techniques;

- around 60 companies seem to have booked sales which might have arisen from investment income or other income;
- at least 10 companies had shifted expenses away from the current period by significantly reducing depreciation rates;
- at least 15 companies which had disbursed the bulk of their loans and advances to companies in which Directors have an interest;
- at least 25 companies had profits shown in the full year results significantly lower than the sum of quarterly results.

These studies establish that the system of certification of accounts of private sector companies is deficient. There is increasing need for regulators like Ministry of Corporate Affairs, Registrar of Companies, Ministry of Finance, SEBI, RBI, ICAI and Stock exchanges to gear up their machinery to curb the unethical creative accounting tendencies, unprofessional conduct of auditors, non adherence to corporate governance tenets and fraudulent transactions of private sector companies including those of listed ones and furthering corporate governance principles in their functioning. It is obvious that the system of audit of financial statements of listed companies advocates that there is a need for oversight functions or supplementary audit not only for audit of PSEs but also for other listed companies in the private sector to protect the interests of large number of minority shareholders.

Three Phased Audit System and Other New Initiatives in Audit of Central PSEs

The root causes of Satyam scam may have yet to be fully investigated and identified; but the fraud has exhibited major accounting irregularities, weaknesses in the control environment, failure on the part of independent directors and the audit committee to ensure corporate governance and negligence on the part of auditors leading to credibility crisis on audit and accounting functions. There is growing expectation gap and demand from the public for re-evaluation of the contemporary Indian accounting and auditing norms, revisiting the audit working processes, principles, procedures and practice to deter possibilities of indulging in deliberate frauds, misreporting and misleading stakeholders.

In order to meet the emerging challenges and to suit the changing environment especially in the backdrop of recent fraudulent transactions in listed companies, the C&AG has issued additional directions to the statutory auditors regarding third party confirmation in respect of bank and cash balances, investment, creditors and debtors while introducing more intensified, innovative, focussed and result oriented approach to financial audit by 'the System of Three Phased Audit'. With a view to bring substantial qualitative transformation in the audit process and methodology, it is imperative to change the mind set of auditors along with innovative strategic transformation in audit approach, targeted to bringing value addition, usefulness, credibility, transparency, visibility and acceptability. Realizing that strengthening the financial reporting system of the PSEs and thereby help implementing internationally benchmarked best corporate governance practices being the ultimate objective of audit, various innovative measures have been initiated for audit of central PSEs recently. Besides, the 'Three Phased Financial Audit System', added emphasis is given to risk based audit approach, corporate governance and

intensification of communication process with all the players concerned including statutory auditors, management and other regulators as well. Some of the strategic changes introduced are briefly given below:

(A) Introduction of ‘Three Phased Audit System’

The prime objective of supplementary audit is enhancing the quality of financial statements. Currently financial statements are cluttered with innumerable notes on accounts, qualifications without quantifying the impact, while certifying the financial statements as true and fair. There is a need for better understanding, effective communication, and exchange of views to bring consensus and convergence of ideas in regard to accounting principles, treatment of different accounting entries, application of mandatory accounting standards among the management executives, government auditors, and the statutory auditors, who are actively involved in the financial reporting and audit process with distinct roles and responsibilities. The ultimate test of a qualitatively superior financial reporting is its readability, simplicity and usefulness to different stakeholders including investors in decision making. Responsibility of an auditor whether he is functioning as statutory auditor or government auditor is essentially strengthening the financial reporting system in the enterprise and thereby facilitating the PSEs to increase its profitability by expanding its core business activities rather than scoring over one another by presenting erudite arguments and counter arguments leading nowhere but help confusing and bewildering the hapless reader of the financial statements. With this objective in mind, a new audit approach viz. ‘Three Phased Audit System’ has been introduced from the accounting year 2008-09 in 78 selected Central PSEs out of total 419 companies and statutory corporations, falling under the categories of ‘listed’, ‘navratna’, ‘miniratna’ government companies, and ‘statutory corporations’ where C&AG is the sole auditor.

The new audit approach has three phases aiming at:

- establishing an effective communication and a coordinated approach amongst the statutory auditors, managements and C&AG’s audit parties for removal of inconsistencies and doubts relating to the accounts presented by the PSEs;
- identify inconsistencies, if any, before approval of the accounts by the Board of Directors (BODs) of the PSEs, review the accounting of transactions and highlight errors, omissions, non-compliances etc. for timely remedial action to improve the quality of accounts;
- providing adequate time and opportunity to the statutory auditors and the managements of the PSEs to examine the issues identified by the C&AG and make necessary modifications in the accounts instead of presenting the accounts along with observations of statutory auditors and comments emanated from the C&AG’s supplementary audit; and
- reducing the time for supplementary audit after the accounts are approved by the BODs of PSEs.

To familiarise the audit entities and the statutory auditors of the objectives and methodology of the of the new audit approach and to elicit cooperation in implementation, 13 high level tri party meetings were organised bringing the

management, government auditor, and statutory auditor for detailed deliberations from December 2008 to January 2009 in Bangalore, Delhi, Mumbai, Hyderabad, Kolkata and Kochi. Detailed guidelines were issued which elucidate the process and procedure as under:

(a) Pre-requisites for Three Phased System of Audit of Annual Accounts

- (i) The PSEs agree to implement the system and extend active cooperation to audit.
- (ii) A proper and scientific audit risk assessment is undertaken before commencement of first phase of audit for assessing audit risk.
- (iii) Effective Interaction among the government auditor, management and statutory auditor for ensuring successful implementation of the system.
- (iv) As far as possible, the same audit team is assigned all the phases of accounts audit.
- (v) The PSEs are expected to give their draft accounts to the concerned Member Audit Board office concerned along with Schedules to the draft accounts for conducting Phase-II of the audit.

(b) Audit methodology

Audit of financial statements may be conducted in three phases as under:

Phase-I

Listed companies prepare quarterly financial results (QFR) and submit to the stock exchanges. Other major companies also prepare QFR or half yearly results (HYR). Phase-I audit is conducted on receipt of QFR of second quarter or first HYR. In case of the companies, which do not prepare QFR/HYR, Phase-I audit was conducted in the months of November-December.

Following aspects are covered in the Phase-I Audit:

- (i) Understanding of the accounting system, including IT system, of the PSE;
- (ii) A proper risk assessment, including review of internal control system⁴ in the PSE, may be conducted;
- (iii) Analysis of accounting policies, notes to accounts with reference to the applicable laws and disclosures in conformity with the accounting standards as per last years certified accounts; In subsequent years, emphasis should be made only on modifications/proposed modifications adoption of new accounting policies, accounting standards, relevant laws and regulations;

⁴ Before taking a decision whether system based audit or direct substantive testing is to be carried out, existence and effectiveness of internal controls is evaluated. If compliance testing of internal control discloses no exception, reliance is placed upon the internal controls and 'System based audit' (SBA) approach can be adopted. In SBA, substantive testing is reduced and number of units and transaction is checked can be reduced substantially. On the contrary, if compliance testing disclosed exceptions that indicate that the controls being tested are not adequate or are not operating properly in practice, the reasons therefore are ascertained. It is also ascertained whether the exceptions are only an isolated departure or a representative of other departures. In case of weak internal controls, detailed substantive testing is conducted.

- (iv) An effort is made to bring consistency in the accounting policies of the companies in the same sector;
- (v) Compliance with the previous year's assurances given by the management and issues raised in the 'Management letters'
- (vi) Previous year's audit findings of the statutory auditors and of the C&AG Headquarters office;
- (vii) Modifications in the opening balances, if any, or rectification of errors done by the company may also be reviewed to evaluate the efficacy of the internal control system;
- (viii) Based on the above (items i to vii), quantum of checks to be exercised and department/units to be visited, scope and coverage is decided. Further audit of the draft accounts to be submitted by the Management is conducted in phase-II;
- (ix) Issues of principle, accounting policies, accounting standards, opinions of the Expert Advisory Committee of ICAI are discussed with the management. Proposed changes in the accounting policies and Notes to Accounts are also discussed;
- (x) Preliminary audit findings emanating from Phase-I and points of disagreements are brought to the notice of the statutory auditors. The Management of the PSE are apprised of these audit findings. The issues involved are reconsidered after obtaining reply of the statutory auditors and the management. Final view is taken at MAB level and communicated to the statutory auditors of the PSE in the form of MAB's sub-directions under Section 619(3)(a) of the Companies Act 1956. The Management of the PSE is apprised of the final view to elicit cooperation towards attainment of the objective of compliance with the accepted commercial accounting principles, applicable laws and accounting standards etc.; and
- (xi) Once remedial action is taken by the management, such cases are to be reported for inclusion in CAG's Report as value addition at the instance of C&AG audit. Cases of points of disagreement are processed as comments on accounts.

Phase-II

This is conducted as a test audit at the end of the financial year (i.e. in the month of April) based on the draft accounts received from the PSEs.

The Following aspects are verified during this phase:

- (i) Audit of the units selected in Phase-I based on draft accounts submitted by the PSE are conducted;
- (ii) Review of system of verification of inventories, cash and bank balances including fixed deposits, Investments and other items to be finalised at

year end and system of confirmation of balances of debtors, creditors, loans and advances, etc.;

- (iii) Instructions issued by the head office of the PSE to its units for compilation/consolidation of accounts. Any deviation in the instructions from the accounting policies, accounting standards etc. are taken up with the PSE;
- (iv) The PSEs are asked timely to render their draft accounts along with Schedules for the period ending third quarter of the financial year to the MAB office concerned for conducting audit in Phase-II. In case any PSE is not in position to render the draft accounts with Schedules, detailed vouching is carried out on the basis of QFRs. Proper documentation with relevant records of the audit/vouching etc. done during the Phase are maintained for subsequent use and reference.
- (v) Preliminary audit findings noticed as a result of test audit and vouching in Phase-II are issued to statutory auditors of the PSU in the form of sub-directions under Section 619(3)(a) of the Companies Act 1956 with a view to ensuring that the statutory auditors conduct, inter-alia, thorough examination of all such related matters. In the event of non-compliance with the accepted commercial accounting principles, applicable laws and accounting standards, the statutory auditors are required to report appropriately in their report on the financial statements. The Management of the PSE is also apprised of the final view to elicit cooperation towards compliance with accounting principles, laws and standards etc.

Phase-III

On receipt of financial statements/accounts duly approved by the Board of Directors of the PSE and reported upon by the statutory auditors, the following aspects are verified during this phase:

- (i) Verification of action taken on earlier audit observations;
- (ii) Compliance with the consolidation/grouping instructions;
- (iii) Review of memorandum of changes effected by the PSE in the approved accounts vis-à-vis the draft accounts on which audit in Phase-II was conducted;
- (iv) Accounting and disclosures of the events occurring after the balance sheet date;
- (v) Final disclosures made in the approved accounts;
- (vi) Compliance with the financial reporting requirements of the relevant laws, rules and regulations, accounting standards etc.

- (vii) Examination of the Report of the statutory auditors especially the qualifications, opinions and compliance with relevant Auditing and Assurance Standards; and issue draft audit observations to the statutory auditors as well as the management and to process the same for issuing as comments on accounts.

(B) System of issue of Management Letter

One of the objectives of supplementary audit is to establish communication on audit matters arising from the audit of accounts between the auditor and those who are responsible for implementing good corporate governance in the entity. Material observations on the accounts of government companies are reported as comments by the C&AG under Section 619(4) of the 'Companies Act, 1956. In addition to these comments, irregularities and systemic and control deficiencies observed by C&AG in the financial reports or in the reporting process are also communicated to the management by a 'Management Letter' for taking appropriate remedial measures. These deficiencies generally relate to application and interpretation of accounting policies and practices, adjustments arising out of audit that may have significant effect on the accounts and inadequate or non disclosure of certain information on which management had given assurance that corrective action would be taken in the following year.

(C) Risk based audit approach

In order to utilise the limited resources of Audit and to help PSUs in managing and minimising the probability of inherent risk of financial impropriety in the activities carried out by them rather than being confronted with surprises on the matters related thereto, a risk based audit approach has been adopted. The objective of this approach is to select high risk areas with focused approach, and conduct systematic in depth audit probe taking statistically chosen representative samples of activities or units of an audit entity. This approach relocates audit focus from coverage of 'all accounting/auditable units' to coverage of 'all major areas of risk' based on objective assessment of risk factors, their significance, materiality and probable impact over a reasonable period of time with definite prompt follow up of audit to see that corrective and preventive actions are in place as a result of audit observations. With a view to give due weightage to financial audit, the audit strategy has been revamped allocating more or less one third audit resources for attestation audit leaving the remaining two third audit resources proportionately for performance audit and compliance audit depending on risk perception.

(D) Interaction with other regulators

In India, the PSEs are governed by number of Regulatory bodies. The common regulatory Bodies are Ministry of Corporate Affairs, Department of Public Enterprises and the Administrative Ministry. In addition, PSEs are also regulated by other bodies like SEBI for listed PSEs, IRDA for insurance sector PSEs, RBI for banking and non-banking financial PSEs, CERC for power sector PSEs, TRAI for PSEs in telecommunication sector, ICAI for ensuring compliance with applicable accounting and auditing standards etc. These regulatory bodies issues guidelines and directions in its domain of operations. As regulatory institutions are aplenty whose jurisdiction, roles and responsibilities may have overlapping common intersections it is crucial to have

purposeful interaction coordination and focused approach among the regulators concerned in a specific sector to help one another executing their assigned job more effectively and efficiently. Besides increasing communication with the Ministry of Corporate Affairs, Department of Public Enterprises, RBI, SEBI and others, various training programmes have been organised in collaboration with some of them on specific emerging issues. ICAI being responsible for ensuring compliance of applicable auditing and accounting standards, 6 Joint workshops are organised with the institute at Delhi, Mumbai, Ernakulam, Kolkata, Lucknow and Jaipur. These workshops were structured to address issues and concerns of CA firms on registration, allocation of work and expectation from them along with dissemination of changes in the Accounting and Auditing and Assurance Standards, International Financial Reporting Standards (IFRS), which are expected to be implemented from April 2010.

Need for Effective Corporate Governance

In spite of various measures taken by the government and regulatory bodies for good corporate governance, there is still need for establishing effective corporate governance system in PSEs for appropriate public accountability of the management. The following issues relating to corporate governance in PSEs are highlighted in the C&AG's report for facilitating government and regulatory bodies for taking appropriate corrective measures to improve the functioning of PSEs:

- Presently Clause 49 of the Listing Agreement of SEBI requires representation of 'independent directors' on the Board and Audit Committee of listed PSEs. There is no provision in the existing Companies Act, 1956 for independent directors on the Board and the Audit Committee even for listed companies. Since substantial public funds are involved in PSEs, it is necessary the Board and Audit Committee of PSEs to have sufficient number of independent directors.
- In addition to Government companies registered under the Companies Act, 1956, there are also certain statutory corporations like Food Corporation of India, Airports Authority of India, National Highways Authority of India and Central Warehousing Corporation established by the Government through special Acts of the Parliament. The Government by making amendments in the Companies Act, 1956 has prescribed good corporate governance practices which are not applicable to the statutory corporations as they are governed by the Special Acts. Consequently these corporations are not required to constitute Audit Committee and prepare Directors'/Members Responsibility Statement despite substantial public money is invested. The Department of Public Enterprises through its guidelines of June 2007 requires all central PSEs to adopt good governance practices but these guidelines are voluntary in nature. With a view to promote more transparent, ethical and fair business practices by statutory corporations, the mandatory provisions for good governance similar to government companies are required to be made for statutory corporations.

- Section 217 (2AA) of the Companies Act, 1956 requires a Directors' Responsibility Statement from the Board of Directors on various matters mentioned above. This Responsibility Statement is part of the Directors' Report under Section 217 of the Companies Act, 1956 which is annexed to the annual financial statements of the company and circulated to the shareholders. This Statement is not the part of the annual financial statements and as such is not subject to review/audit by the auditors. In spite of the assurance given by the Board in their 'Responsibly Statement' that annual accounts are prepared in accordance with applicable accounting standards, number of instances of non-compliances with the provisions of accounting standards are being noticed every year by the statutory auditors and government auditors and reported in their respective audit report. This indicates that the Board of such PSEs does not give the correct statement under Section 217(2AA) of the Companies Act, 1956 to the stakeholders. As this statement is out of the purview of audit, there is no system of its authenticity and may mislead to stakeholders in case of wrong statement.
- Though clause 49 of Listing Agreement requires specified number of independent directors on the Board of PSEs, it was observed in a review by Audit that out of 44 listed government companies, the Board of 30 companies had not been constituted as per clause 49 of the Listing Agreement as it did not contain the required number of independent directors. Similarly, for unlisted PSEs, DPE's guidelines of 1992 require that at least one-third of the Directors on the Board of a CPSE should consist of non official directors. A review found that the Board of 64 unlisted government companies had not been constituted as per the DPE's guidelines as it did not represent the required number of non official directors. Since the power to appoint the directors on the Board of PSEs vests with the Government, there is need to take appropriate action for the induction of independent or non-official directors on the Board of deficient government companies.

Conclusion

The inevitable solution to persisting and pervasive financial irregularities, creative accounting jugglery, non compliance of applicable laws, standards and principles, systemic and control deficiencies in the corporate sector in particular private sector companies leads to ensuring effective implementation of internationally benchmarked best practices of corporate governance. No doubt, the statutory frameworks are in place, mandatory acts, regulations, rules, standards, principles, procedures, directions, guidelines and best practices are well known and aplenty; regulatory bodies overseeing the corporate business activities for effective enforcement are constituted, alive, kicking and functioning; and board of directors, audit committee, independent directors, statutory auditors and government auditors are all in the corporate arena seized of the problems and issues with defined roles, tasks and responsibilities. Nevertheless effective implementation of corporate governance has a long way to go. Time has come for

cooperation coordination intense focused result oriented interaction, exchange of views among all the players in the corporate arena for better approach, methodology, and action plan to help one another in discharging their assigned role by coordinated and collective action.

Financial statements, reporting and audit process are some of the significant instruments which can help effective implementation of corporate governance by value addition, building credibility, usefulness and investor confidence. Strengthening the monitoring and enforcement mechanism necessarily requires appointment of independent and competent auditors. Some of the important issues to be considered are facilitating coordination among multiple regulatory bodies, bridging the gap between IFRS and Indian Accounting Standards, International Standard on Auditing (ISA) and Indian Auditing and Assurance Standard and most importantly, introducing effective mechanism to enforce adherence to professional code of ethics by the auditors.

Failures in corporate governance may lead to clamor for giving birth to more regulatory bodies in the form of regulator of regulators, independent auditor of auditors, independent national audit oversight bodies etc. replicating the pattern of USA, UK, Australia, Canada, Japan and European Union rather than evaluating and revisiting the role and responsibility structures of the existing regulators and taking appropriate measures for monitoring and enforcement of good corporate governance. The office of the C&AG has reviewed its role and responsibility in the context of recent corporate governance failures and geared up its machinery to ensure accountability, transparency, probity, equity and fairness in the audit of PSEs. As the Supreme Audit Institution of the country the C&AG of India has an important role in facilitating implementation of good governance of PSEs by reporting significant and material audit findings along with recommendations for remedial action in his audit reports wherever deemed necessary.

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