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Auditor's Independence and Corporate Fraud

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ABSTRACT This paper discuses some aspects of the independence of external auditor and corporate fraud. The author examines the adequacy of auditor's independence and determines whether or not inadequacy of auditor's independence is responsible for corporate fraud. Carty (1991: 60) said: " Fraud has rarely been out of the headlines recently: Guinness, Dunsdale Securities, Nicholas Young and now the daddy of them all, BCCI"; and he continued, "fraud of every kind is on the increase. Over 90% of major fraud cases are dealt with by the Fraud Investigation Group (FIG) of the Crown Prosecution Service. Fraud Investigation Group's work load is approaching 900 fraud cases and increasing". In a descriptive manner, however, the paper examines: (a) qualities required of professional external auditors; (b) auditor's independence - statutory regulations; (c) regulatory bodies such as Institute of Chartered Accountants in England and Wales (ICAEW); Institute of Chartered Accountants of Nigeria (ICAN); American Institute of Certified Public Accountants (AICPA); and Chartered Association of Certified Accountants (CACA), with their ethnical guidelines on auditor's independence; and deficiencies in the present practice. A few suggestions are finally put forward which, if accepted, would improve the performance of auditors and make corporate fraudsters to think twice before making any move.

INTRODUCTION

The *English Illustrated Dictionary* (1990: 331) defines "Fraud" as 'deceitfulness', 'criminal deception' and using false representation to obtain unjust advantage. For the purpose of this paper, we would settle, for the definition of 'criminal deception'.

'Independence' has become an emotive word, a banner standing for freedom, integrity and all that is good. The word independence has two distinct meanings. Firstly, it falls within a family of words implying 'an absence of relationship' for example, like unrelated, disconnected, isolated, remote and insular. Perhaps this is the reason why, in the olden days, auditors were often required to hold shares in their client companies so as not to be too ' independent'. Secondly, 'independence' falls within a family of words implying freedom from the exercise of powers, for example: free, unhindered, emancipated and free from dominance or influence. These are good qualities of independence, unlike the above meaning which suggests bad sense.

Professional independence, however, is a concept fundamental to the accountancy profession. It is essentially an attitude of mind characterized by integrity and objective approach to professional work. But why is it desirable that an auditor be independent to enable the objectives of an audit to be achieved? It is desirable because the auditor cannot give unbiased opinion unless he is independent of all the parties involved. And that objectivity can only be assured if the auditors is, and is seen to be independent. But independence is impaired by a material interest: service as an officer or trustee to a client; loan to or from a client; and undue dependence on an audit client.

What is an audit? Attwood and Stein (1986: 12) put the definition of an audit succinctly as "Checking somebody else's accounting", while Meig et al. (1982: 28), put it as "an examination or investigation by independent public accountant of a set of financial statements, and the accounting records and other supporting evidence, both within and outside client's business". The Institute of Chartered Accountant in England Wales (ICAEW, 1985: 3) defines an audit as:

The independent examination of, and expression of an opinion on the financial statements of an enterprise by an appointed auditor in pursuance of that appointment and in compliance with any relevant statutory obligation.

But what are the fundamental objectives of auditing? Millichamp (1993: 2) put the primary objective of auditing thus: "To produce a report by the auditor of his opinion of the truth and fairness of financial statements so that any person reading and using them can believe in them". He further gives the subsidiary objectives as detection of errors and frauds; prevention of errors and frauds by the deferent and moral effect of the audit; and finally the provision of 'Spin-off' effects, which are the assistance given by the auditor to client with accounting; internal control system; taxation; financial and other problems.

CORPORATE FRAUDS

'Failed Bank Decree' has opened the eyes of the business world to the on-goings in the both Commercial and Merchant Banks in Nigeria. Millions of dollars have been fraudulently taken or stolen from the sector. And in the international arena, Singleton-Green (1991: 1) described BCCI debacle as "the largest bank fraud in world financial history".

The merchants of the Italian city states in the 15th century employed the services of auditors to verify the 'figures' provided by the sailing ship captains. The results of the auditors failing to make such a check is serious and liable to damages. The objective of the audit was to detect fraud and no changes in this practice took place until recent times. Today, the detection of fraud as a primary objective of auditing has disappeared. Although in practice, it would be necessary to detect a major fraud in order to ensure that the accounts show a true and fair view.

The Public Opinion

Like in the times past, the public opinion on the work of the external auditor is to detect fraud. The recent cases of fraud have caused the public to have adverse comments ton the services of the external auditors. Some people, in Nigeria, even advised the government to put the external auditors of the failed banks before the 'Failed Bank Tribunal' for negligence. If businesses did not go bust, the auditors would not have to worry about their reputation. But businesses do fail unexpectedly, and the auditor is usually blamed either for not spotting that something was wrong or for not realizing that something was about to go wrong.

In order to do this onerous duty, the external auditor must possess certain qualities. What are these qualities? And what are the statutory and professional regulations guiding the auditor in the performance of his duty? ' Statutory Regulation' concerning auditor's independence is clearly stated in the Companies and Allied Matters Act (CAMA) 1990a, section 358 (2) as follows:

None of the following persons shall be qualified for Appointment as auditor of a company: (a) an officer or servant of the company; and (b) a person who is a partner of or in the employment of an officer or a servant of the company.

The idea behind this statutory regulation is to make an auditor independent of client company.

REGULATORY BODIES

Accountancy profession in recent times has had a bad press. Consequently, the profession has to fall on 'self regulation'. Rules of professional conduct came into being through series of guidelines from notable bodies like the Institute of Chartered Accountant in England and Wales (ICAEW);Institute of Chartered Accountants in Nigeria (ICAN), American Institute of Certified Public Accountants (AICPA); South African Institute of Chartered Accountant (SAICA)and Chartered Association of Certified Accountants (CACA). Millichamp (1993: 47-48) gave the Ethnical Rules of the bodies mentioned above which may threaten or appear to threaten the independence of an auditor thus: undue dependence on audit client; and that independence may be put in jeopardy if the fees from any one client exceed 15% of gross practice income.

Family or Personal Relationship

It is desirable also to avoid professional relationship which includes mutual business interest with officers or employees of the client company. Beneficial interests in shares and other investments in client companies should be avoided. An auditing practice, or anyone closely connected with it, should not make or receive loan from client companies except from banks in the normal course of business. Goods and services should not be accepted by a practice or anyone connected with it, unless the value of such gift is modest.

In order to maintain independence, audit firm should review on an annual basis every client to determine if it is proper to accept or continue an audit engagement bearing in mind apparent threats to audit objectivity.

Competence

An auditor must be thoroughly trained, and prove his competence before he can sign an audit report. Initially, only ICAN members can sign financial statements in Nigeria, but General Babangida on his last day in office signed Association of National Accountants of Nigeria

(ANAN) Decree, making two bodies of Accountants in Nigeria.

Integrity

Qualified accountants are renowned for their honesty, discretion and tactfulness. An auditor should always act with integrity, honesty, and probity and must maintain a professional attitude in the performance of his responsibilities. He should in public practice not follow any other occupation which is inconsistent with his professional duties.

Deficiencies in Present Practice

We have seen from this paper efforts made by Regulatory Bodies and Statute (CAMA, 1990b) to make auditors independent. Do auditors still lack the independence they need to do their job with impartiality? For there is no direct evidence yet to show that 'inadequate independence of auditors is responsible for corporate fraud'. But this paper will show that in practice, auditors are appointed and their remuneration are fixed by the directors. Simon (1980: 105) remarked thus:

Although the auditor is in theory appointed by the members of a company, in reality, it is often the director (Management) upon whose stewardship the auditor is to report, who actually appoint the auditor and fix the fee.

In addition, the following companies have one thing in common in their 'Notice to Annual General Meetings': (a) Union Bank of Nigeria PLC - Notice to Annual General Meetings for the accounting Years ended 30th September, 1994, 1995, and 1996. (b) National Oil and Chemical Marketing PLC - Notice to Annual General Meetings for the accounting Years ended 31st December, 1993, 1994 and 1995. (c) African Petroleum PLC - Notice to Annual General Meetings for the accounting years ended 31st December 1993, 1994 and 1995. in each of the three years and of the three companies mentioned above, one important item of the agenda to be discussed is:

To authorize the Directors to fix the remuneration of Auditors.

The above quotation referring to the fixing of the auditor's remuneration undermines the independence of the auditors because "he who pays the piper dictates the tunes". And this shoddy arrangement of directors fixing the auditor's remuneration placed many auditors in a financial jam, because wherever the auditor's report implicates the directors, they may take undue delay in fixing the auditor's fees and may not give a quick release to fund to pay auditors, thereby giving rise to the saying - "Last to be paid, First to be blamed". Wright (1987: 72) wrote:

The directors of company registered under the companies Act are required to lay before the company in general meeting accounts in respect of each financial year. The accounts must comply with the requirements of the Act as to form and content.

The auditors are required to report to the members of the company on the account so presented by the directors, and the auditor who has been financially 'pocketed' by the directors will have to compromise his position. It is central to the auditor's purpose that his position should be one of 'independence' and 'objectivity' so that he can attest to the credibility of the financial statements presented by the directors to the members, in AGM without fear or favour.

The collapse of many Commercial and Merchant Banks, as reported in Nigerian Press, because of frauds; and Robert Maxwell, 'looting' about \$420m in all from his company's pension fund, as reported by Singleton-Green (1992: 1) and also with BCCI so far the biggest fraud in history, amount to nefarious practices of directors. *The central point of this paper, therefore, is that if the auditors are not financially 'pocketed' by directors and the (auditors) are totally independent, honest , and competent, fraud will hardly occur, and if it does, it will be exposed soonest.*

SUGGESTIONS FOR IMPROVEMENT

The following are the suggestions put forward by the author to improve on areas of weakness on auditor's independence mentioned above. First, Jubb (1979a: 103) informed us that in North America audit committees were developed in a climate in which there was a need to give shareholders added assurance as to the objectivity of financial statements. It is very possible that this evolutionary pattern will be paralled in Nigeria in due course. The audit committees we have in Nigeria today are in the era of experimentation. The objectives of the audit committees were put by Jubb (1979b: 103) as:

The primary financial objective of audit *committees is to give added assurance as to the adequacy and reliability of financial information prepared by the directors and management for distribution to shareholders and other interested persons.*

There are three secondary objectives: (a) to be assured that the external auditors have performed an effective, efficient and independent audit; (b) to provide an independent reporting channel for the auditor; and (c) to monitor implementation of recommendations from external and internal auditors.

While the objectives - primary and secondary are apt, the composition of members of audit committees in Nigeria does not allow for full independence, because the membership of audit committees in Nigeria include "the directors of the same company". In order to improve the independence of auditors, the following suggestions are provided as follows: First, there should be an abolition of compulsory audit of the smaller companies (Hughes, 1992: 103) because there is little or no difference between the shareholders and the directors and the composition of audit committees will be meaningless in that way. Secondly, the composition of members of audit committee should exclude the company's own directors (executive or non- executive). Thirdly, the committee should be headed by a qualified accountant, who should not be below the level of 'Fellow' in status.

Appointment and Fixing of Remuneration

The external auditor should be appointed by members in Annual General Meeting (AGM) with a recommendation from the Audit Committees, who by their training and composition should know the worth of the auditor. Should there be a sudden vacancy, the audit committees should have power to fill the vacancy subject to the approval of members in AGM. The directors should have nothing to do with the appointment of the external auditor. Where there are no audit committee in place, at the commencement of the company, the power that chooses the first directors, the Audit committees should also appoint the first external auditors. In the Government parastatals, the authority that appoints the board of directors should always appoint the first external auditors. Government should not allow the board to choose the external auditors that will audit the board's own activity. They (the directors) should have nothing to do with the fixing of the audit fees. The audit committee which is to ensure that the external auditors have performed an effective, efficient and independent audit should be in position to fix the remuneration of such assignment. The company's directors should have nothing to do with the fixing and payment of audit fees.

The Government should have audit committees for all their parastatals. The audit committee (AC) appointed by the government should see that the external auditor performs an effective and efficient auditing. The external auditor should submit his report to the AC, which should then implement all the recommendations. Those items of which the government should act upon must be communicated to the government without delay, otherwise communication to the government by 'exception' should apply. This means audit committee should not write the government if there is no material breach of duty and fraud. The implementation of the external auditor's recommendations on the parastatals should be 'total'. And the fixing of the audit fees of all parastatals should be by their respective audit committees. And, finally, the chairman of the audit committees should be a qualified accountant with a status of a 'Fellow'

In conclusion, Woolf (1978: 99) observed further that:

The real answer to this aspect of the independence question is therefore to ensure that auditors are able to perform their onerous duties without fear or latent threat of removal, if they dare to demonstrate what the directors may regard as "excessive zeal" and this objective can be achieved only by placing the security of the auditor's position totally beyond the whims and fancies of directors.

Finally, if the auditor is totally independent, honest and competent, there will be strength in his objectivity and a fraudster have to think twice before making any move.

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