Ranee Jayamaha: Role of external auditor and implications of the new Companies Act

Speech by Dr Ranee Jayamaha, Deputy Governor of the Central Bank of Sri Lanka, at a seminar at the Central Bank of Sri Lanka, Colombo, 11 June 2007.

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Given the rapidly expanding financial landscape in Sri Lanka in which finance and leasing companies are making a significant contribution to the financial services industry, it is imperative that the role of each stakeholder is recognized for purposes of clarity, financial reporting and in the interest of wider financial system stability.

The business of finance, hire purchase and leasing has grown significantly in the last few years, but at a lower pace than that of the banking sector. In 2006 alone, the growth in leasing portfolio of banks was 80%, while the finance companies and leasing companies recorded growth rates of 13% and 6%, respectively, in their lease portfolios. Banks and finance companies have access to low cost funds through deposit mobilization. Here too, banks have current accounts at zero costs. Leasing companies, on the other hand, rely on bank borrowing or borrowing through debt instruments which is costly to them. Recently, the Central Bank has recommended amendments to the Leasing Companies Act to regularize leasing company borrowings from the public through the issue of debt instruments. The Central Bank will monitor such borrowings to ensure that highly geared leasing companies do not borrow excessively from the market and terms and conditions will be imposed to mitigate risks to the investors in debt instruments issued by leasing companies.

In addition to business growth and fund raising, the viability of the finance and leasing companies should also be monitored and watched, although their asset base accounts for a mere 4.8% of total financial sector assets. Also, these institutions are engaged in granting credit to the more risky sectors in the economy absorbing higher credit risks which the conventional banking sector is not willing to take on. Their contribution to the capital formation in the economy particularly through the provision of leasing and hire purchase facilities is significant. A failure of one or two big companies would have a far reaching impact from a stability point of view, given the ripple effects it could have on the whole financial sector. There are several stakeholders involved in examining the viability of businesses of finance and leasing companies. The chief among them are shareholders, regulators, auditors, investors, depositors and creditors. All these stakeholders have functions and responsibilities assigned to, or assumed by them by law or practice. It is becoming increasingly clear that some of the functions and responsibilities will not be effective if done in isolation without consulting the other stakeholders. In particular, the regulators and external auditors should closely coordinate their roles and responsibilities. The regulator as well as the external auditor starts their examinations and audits with the financial reporting aspects of companies. The external auditor is basically looking at the financial performance of the company and its compliance with the laws, observance of auditing and accounting standards and rules and regulations set out by the regulator. They also look into aspects such as health of the balance sheet, status of the profit & loss account and the ability of the company to operate as a going concern. The regulator, on the other hand, has to make sure that not only companies adhere to provisions in the governing laws and comply with rules and regulations but also ensure that finance and leasing companies have put in place necessary processes and procedures to mitigate risks, be it credit, liquidity, market or systemic. The regulator makes recommendations to initiate action, if such risk mitigation methods are not considered adequate. The regulator is conscious of not only the viability of the company to operate as a going concern, but also its ability to pay its liabilities to creditors and depositors. Sometimes, there is an over-lapping of the two roles of the regulator and external auditor, but with closer dialogue, coordination and cooperation, the duplication of work can be avoided.

The regulator should have quarterly/monthly dialogue with the companies and external auditors which is a healthy practice than working on an isolated basis. It is also important to understand financial reporting formats and the auditing standards specified by the external auditors and ensure that there are no conflicting instructions issued by the regulator or the external auditor. This task can also be facilitated through continuous dialogue between the relevant parties and in forums like this, where such issues can be raised and resolved.

Neither the regulator nor the external auditor can ensure that the companies are acting in a transparent and an accountable manner. The boards of directors and the senior management should be accountable to relevant stakeholders. This is why it is necessary to adopt corporate governance practices both at the board level and throughout the operations of the institution. There is an increasing trend of making some of the corporate governance practices mandatory either through rules and regulations issued by the regulator or by separate mandatory codes. From 2009 onwards, all finance and leasing companies will have to observe mandatory governance principles. Therefore, contribution by the boards of directors and the senior management of finance and leasing companies is extremely important as it will facilitate the roles of both regulator and auditor.

The role of an auditor under the new Companies Act

Given the fiduciary responsibility of finance and leasing companies, it is important to differentiate normal company audits from financial institution audits. Auditors are appointed by the shareholders, but their prime responsibility should be to ensure that the company can function as a going concern and pay back the depositors' funds as and when needed. The auditors' opinion lends credibility to the financial statements and promotes confidence in the system.

Auditors generally cover their opinion with a statement in which they certify accounts of the company as true and fair on the basis of information made available to them. While recognizing this clarification, in the interest of wider financial system stability, it is important that external auditors find out the true position of the company and alert regulators, even though it is beyond audit ethics. The audit profession should be independent and they must win confidence of the investing community and the general public by providing accurate and timely audits. In that sense, external auditor also performs the "watchdog's" and the "whistleblowers" role in the financial system.

The new Companies Act, which came into being just a month ago, is somewhat explicit in the role of the auditor in the following areas:

1. **Fair judgment**: An auditor shall ensure that his judgment is not impaired by reason of any relationship with, or interest in the company or any of its subsidiaries. While regularizing the company under audit, as its client, the auditors must distance themselves in judging the true financial status of the company.

2. **Issue of certificate of solvency**: The new Companies Act strictly looks at the company's ability to meet the solvency test at the time of a distribution. Distribution does not only refer to dividends but also to the transfer of property, incurring of debt to or for the benefit of shareholders. An auditor needs to issue a Certificate of Solvency assuring compliance with the solvency criteria. This is something new in the new Companies Act and it is specially relevant to finance and leasing companies which deal in depositors/lenders' funds with fiduciary responsibilities.

   Also, before the board of a company resolves to reduce its stated capital (as companies have the option of buying back its own shares), the board shall obtain the auditors certificate of solvency.

3. **Determination of fair value**: The new Companies Act enables a company to purchase its own shares provided an auditor opines that the consideration given is a fair value (i.e. market value). If a company is to alter the Articles to reflect a removal or an addition of business activity or to carry out a major transaction or an amalgamation, minority shareholders could request the company to purchase their shares. Auditor has to make a fair judgment on this, which is introduced as a facility to minority shareholders. Unlike in the previous Companies Act, the external auditor is given a specific responsibility in making the judgment.

There may be several other clauses in the new Companies Act which casts additional responsibility on the external auditor. There are experts to discuss these topics in this Forum and let me not pre-empt them. I hope the deliberations today will bring such issues into light and that there will be a meaningful discussion.

I wish the seminar a success.