

## **A RE-ASSESSMENT OF AUDITORS' OFFICE IN ENHANCING ACCOUNTABILITY**

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### **ABSTRACT**

*In the context of contemporary corporate atmosphere, auditors are pivotal. They act as a financial guardian in the interests of stockholders and stakeholders. Hence, there is a gradual trend of increasing reliance on auditors and their report. Most importantly, the report is lodged at the Companies Commission of Malaysia to enable stockholders and stakeholders to view the report. Hence, this study will examine the office of auditors pertaining to laws governing eligibility, appointment, qualification, disqualification, resignation and removal. The study will determine whether there are any weaknesses in the relevant laws which contribute to the passive role played by auditors. The study then proceeds to scrutinise whether the powers and rights entrusted to the auditors are adequate in protecting the interests of the stockholders and stakeholders. In doing so, the study will show that the powers and rights of the auditors are superficial in truly*

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*protecting the interests of the stockholders and stakeholders. The study will then recommend the necessary reforms to be made to the relevant provisions of the Companies Act 1965 to enhance the accountability of auditors. This is important since there is also a growing trend to make professionals more accountable.*

## INTRODUCTION

This study examines the meaning of the term ‘auditor’ and the various terms attached by the legislature and the courts on auditors. The study then proceeds to investigate imperative issues on the office of auditors concerning eligibility, appointment, removal, rights, privilege and powers. This is to enhance the accountability of auditors to bring about a more meaningful existence of the auditors. In doing so, the study will explore the necessary reforms that should be made.

## DEFINITION AND MEANING

In Latin, the term ‘auditor’ means ‘listening.’<sup>1</sup> This suggests that auditors are dependent on the information provided by the relevant key personnel of a company in order to prepare the auditors’ report on the company’s accounts. This means that the information provided in the auditors’ report depends on the accuracy, genuineness and truth of the information provided by the relevant key personnel.

However, in contemporary corporate atmosphere, such an understanding and usage of the term auditor is not appropriate. This is because auditors are now in a unique position. They are required to examine documents and financial information.<sup>2</sup> They verify the company

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<sup>1</sup> Aishah Bidin, *Undang-Undang Syarikat di Malaysia*, (Kuala Lumpur: DBP, 2001) at 230.

<sup>2</sup> Sin, Boon Ann, “The Duty of Care of Auditors: To Whom Should the Duty be Owed” [1990] 3 MLJ iii.

accounts in detail. They watch, observe and report on the company's financial affairs. Thus, audit has been defined as "a skilled examination of such books, accounts and vouchers as will enable the auditor to verify the balance sheet of a company."<sup>3</sup> Furthermore, they perform important advisory, reporting, investigatory, regulatory and administrative functions.<sup>4</sup> Although, there will be reliance and dependence on the information provided by the relevant key personnel, being experts, auditors are required to use their own professional judgment and skill. They are trained professionally to audit company accounts independently. Therefore, the function of auditors is more than just merely listening. This is what auditing means in most countries.<sup>5</sup>

Notably, the term 'auditor' is not defined in the Companies Act. Nonetheless, the term 'approved company auditor' is interpreted in section 4(1) of the Companies Act as "a person approved as such by the Minister under section 8 of the Companies Act whose approval has not been revoked." This interpretation is inadequate as it does not define who an auditor is. It merely interprets who an approved company auditor is. The provision assumes that one knows what the meaning of auditor is, instead of first interpreting who an auditor is. If the term auditor was interpreted, it would be a precursor to understanding the role and duties of auditors.

In the absence of an interpretation of the term auditor, its meaning is left to an individual's interpretations. As such, there are differences in the interpretations. In some cases, the interpretations may be vague. The term will be interpreted according to one's own understanding of the role and duties of auditors. The understanding of the role and duties of auditors will differ from person to person. This is especially because there are various persons and bodies who have interests in the subject matter namely existing individual shareholders, directors, the audit committee, prospective shareholders, employees, creditors, guarantors, companies wishing to exercise takeovers and mergers, trustees, beneficiaries, regulatory bodies, government, professional bodies and

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<sup>3</sup> Geoffrey, R Masel, *Professional Negligence of Lawyers, Accountants, Bankers and Brokers*, 2<sup>nd</sup> ed., (North Ryde, N.S.W: CCH Australia Ltd, 1989).

<sup>4</sup> Jackson, R M & Powell, J L, *Professional Negligence*, 4<sup>th</sup> ed. (London: Sweet & Maxwell, 1997) at 804.

<sup>5</sup> Normanton, E.L., *The Accountability and Audit of Governments*, (New York: Manchester University Press, 1966) at 22-23, 57-58.

members of the public. This will also mean that there will be different expectations from those persons and bodies as regards to auditors' role and duties.<sup>6</sup> Consequently, there will be an expectation gap between what is expected by those persons and bodies and what is delivered by auditors.<sup>7</sup>

Furthermore, since terms such as 'contributory,' 'director,' 'officer,' 'official receiver' and 'promoter' are defined in the interpretation provision of section 4(1) of the Companies Act, the legislature should also include the interpretation of the term 'auditor.' This would give a comprehensive and uniform understanding of auditors' role and duties among those persons and bodies as afore-mentioned. The interpretation would then serve as a benchmark.

Notably, section 9(3) of the Companies Act provides that auditors are not officers of the company for the purposes of this section *i.e.* section 9 of the Companies Act. Furthermore, section 4(1) of the Companies Act defines explicitly, the term 'officer' and it does not include auditors. Thus, it is clear that auditors are not officers of the company from the Companies Act point of view. Nonetheless, auditors were considered as officers of the company by the English court in *R v Shacter*.<sup>8</sup> There is therefore a conflict between the approach taken by the Companies Act and the view of the English court. If an auditor is an officer of a company, it means that he is attached to the company. An auditor is not attached to the company as he is required to be independent of the company. This is to ensure that he is not subject to any form of direct or indirect control by any person in the company. Hence, the approach taken by the Companies Act is correct and it is submitted that the approach of *R v Shacter* is incorrect as regards the point that an auditor is an officer of the company.

In another decision, auditors were regarded as agents of the shareholders by the English court in *Spackman v Evans*.<sup>9</sup> This means that there is an agency relationship between auditors and the shareholders whereby the latter is the principal. The court found so since auditors are required to report on the company's accounts to the shareholders.

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<sup>6</sup> Hian, Chye Koh & E-Sah, Woo, (1998) *Managerial Auditing Journal* 13(3) 147.

<sup>7</sup> Liggio, C D, "The Expectation Gap: The Accountants Waterloo," *Journal of Contemporary Business* 3(Spring) 27– 44.

<sup>8</sup> [1960] 2 Q.B. 252.

<sup>9</sup> (1868) LR 3 HL 171.

Nonetheless, the concern is whether auditors can be independent of the shareholders if they are considered as agents of the shareholders. This is because it is trite law that an agent has to obey the instructions of his principal.<sup>10</sup>

Thus, in the context of auditors, they have to obey the instructions of the shareholders. In actual fact, auditors are not required to obey the instructions of the shareholders. Essentially, they are not required to obey the instructions of anyone except the company, which is to audit the company's accounts. If the approach by the court in *Spackman v Evans* is adopted, difficult issues can arise in cases where it is found that the majority shareholders have been appropriating the company's property to the detriment of the minority shareholders. This is because the majority shareholders may exert pressure on the auditors not to report the matter in the report. Applying the agency theory, it means that the auditor must carry out the instructions of the majority shareholders. Thus, it is submitted that the view of the court in *Spackman v Evans* that auditors are the agents of the shareholders is incorrect. Additionally, auditors are also not ordinarily agents whose acts bind the company.<sup>11</sup>

## **ELIGIBILITY**

Section 8(1) of the Companies Act provides that a person may be appointed as an auditor of a company if he is approved by the Minister of Finance. This shows that prior approval must be obtained before taking up the position of an auditor. In granting the approval, the Minister must satisfy himself that such a person is capable of carrying out auditing functions and is of good character. This shows that the position of an auditor is regulated by the law and the government. However, in most cases, it is a firm that will be approved rather than an individual.<sup>12</sup> If a firm is appointed, then every member is deemed to be appointed. Thus, the criteria of good character is required of all the auditors in the firm as required under section 4(1) of the Companies Act.

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<sup>10</sup> Section 164 Contracts Act 1950.

<sup>11</sup> Smith, K & Keenan, D J, *Company Law*, 3<sup>rd</sup> ed., (London: Pitman, 1977) at 241.

<sup>12</sup> Lewis, J R & Cheah F S, *Student Handbook of Malaysian Company Law*, (Kuala Lumpur: Cedar Publications, 1997) at 89.

Notably, the approval is not based on an indefinite period of time as it is renewable every two years. This also shows that the government regulates an auditor's eligibility not only at the initial stage but throughout an auditor's career. Again the concern is whether there have been any cases where there was no renewal.

If an auditor is found to be eligible in the initial stage but ineligible subsequently, rightfully, the Minister should revoke the approval before the two years expires. Again the concern is whether the Minister has exercised this right and to what extent. If in the event the Minister fails to revoke, then the provision which empowers the Minister to revoke is left redundant. Ideally the provision should read to the effect that an approved company auditor shall cease to be so if he is found to have breached his duties under the Companies Act. Thus, the auditor should not be allowed to renew his license. In such a case, the provision is triggered the moment a breach has taken place. In that case it will not depend on the discretion of the Minister.

The term 'approved company auditor' within the purview of section 4(1) of the Companies Act gives an impression to companies at large, that the particular auditor is capable of auditing and is of good character. Thus, the Minister must exercise his powers carefully to ensure that only qualified persons are eligible. Thus, difficult issues can arise in cases where a Minister has approved a person as an 'approved company auditor' and thereafter it was discovered that the person is not capable of performing auditing duties. Matters could be more difficult in cases where auditors have acted fraudulently previously but the Minister has failed to detect such wrongdoings. This is because in cases involving fraud, it is clear that the auditors did not act honestly and therefore are not of good character. The concern is whether the relevant Minister who made the approval could be held accountable in allowing such incapable and dishonest persons to be 'approved company auditors.'

Observably, the duty of the Minister in approving persons as auditors cannot be merely administrative as the duty should also involve supervisory functions *i.e.* approving only qualified persons to be auditors. Since good character is one of the criteria to be taken into account by the relevant Minister to approve a person as an auditor and good character involves honesty, the relevant Minister should have checked the background of the person before exercising his discretion. Thus, the Minister should be held responsible and accountable in cases where there have been fraudulent and dishonest practices by the auditor concerned.

Essentially, auditors who are involved in fraud should not be eligible to be approved as a company auditor. This is to restore the confidence in the role of the auditors. The Minister should play a proactive role in ensuring that the role of auditors is given due consideration.

A further difficult matter is that it is not clear as to what extent 'good character' is a determining factor on the part of the Minister's decision in approving a person as an 'approved company auditor.' This is because there is no definition, interpretation and explanation of the term 'good character' in the Companies Act. Additionally, there is no person or body entrusted with the duty of educating auditors concerning what amounts to 'good character.' Thus, the requirement of good character will be taken lightly by the auditors.

The auditors are expected to have their own knowledge and understanding on the subject matter. This creates inconsistencies among the auditors. The benchmark of what is good character is subjective. The auditors cannot be expected to display a uniform standard of what is good character. Ultimately, there will be expectation gaps between what is good character from the auditors' point of view and what is good character from the Minister's point of view.

Furthermore, the term good character may have different meanings to existing individual shareholders, directors, audit committee, prospective shareholders, employees, creditors, guarantors, companies wishing to exercise takeovers and mergers, trustees, beneficiaries, regulatory bodies, government, professional bodies and members of the public. The consequence is that there will be different standards expected of the auditors. Essentially, good character must be maintained by the auditors throughout their career. This is because possessing academic and professional qualifications, knowledge and experience alone are insufficient. The personal make up and character of the person is also important.

Although 'good character' is a requirement to be an auditor, the concern is whether in reality it only serves a theoretical purpose. Nonetheless, this should not be the case. The nature of the auditing function requires substantial amount of truthfulness and credibility. In fact auditors are under a duty to be honest.<sup>13</sup> It should be noted that

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Hardy, Ivamy ER, *Topham and Ivamy's Company Law*, 16<sup>th</sup> ed., (London: Butterworth, 1978) at 290.

auditing involves professional skills. However, reporting what has been discovered involves honesty which consequently, is connected to good character. Thus, equal importance should be placed on this aspect. In fact judgments and actions of auditors are a reflection of the virtues as enacted by the auditing profession.<sup>14</sup> Essentially, it was found that one of the most important virtue auditors should have is honesty.<sup>15</sup>

Hence, a significant step must be taken in relation to educating auditors of what is 'good character.' Thus, it is recommended that a special body be formed to educate auditors of what is good character. Good character must play a vital role in deciding whether a person should be an 'approved company auditor.' This will send a strong message to the auditing profession that the matter is not taken lightly. The auditors will begin devoting quality time in improving their 'software' strength.

Although auditing skills and good character act as twin pillars to be eligible for appointment, in some instances, persons who wish to become approved company auditors may be disqualified by the Companies Act. The disqualification is enumerated in section 9(1) of the Companies Act which provides that it is an offence to act as the auditor of a company if he knows that he is disqualified. This is aimed to ensure the independence of the auditor in auditing company accounts.<sup>16</sup> It is also to ensure that existing individual shareholders, directors, audit committee, prospective shareholders, employees, creditors, guarantors, companies wishing to exercise takeovers and mergers, trustees, beneficiaries, government and members of the public receive an unbiased opinion on the 'true and fair view' of the company's financial position. Thus, independence is seen as a key factor for non-biasness as pointed out by the English court in *Re Transplanter (Holding Co) Ltd.*<sup>17</sup>

The provision also acts as a proactive mechanism in eliminating auditors who may have bias since auditors must be of good character. It is also to ensure that auditors are not in any way influenced by the officers of the company. Otherwise, there may be a possible conflict of interest.

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<sup>14</sup> Mintz, S M, "Virtue Ethics and Accounting Education," (1995) 10(2) *Issues in Accounting Education* 246-67.

<sup>15</sup> Theresa, Libby & Linda, Thorne, "The Identification and Categorization of Auditors' Virtues," (2004) 14(3) *Business Ethics Quarterly* 479-498.

<sup>16</sup> Iacobucci, F, Pilkington, M & Prichard, J R S, *Canadian Business Corporations*, (Aurora: Canada Law Book Ltd, 1977) at 390.

<sup>17</sup> [1958] 2 All ER 711.



This is different from the legal position in the United Kingdom previously where it was a common practice that auditors were the shareholders of the company.<sup>18</sup> However, significant changes were made in 1900 disallowing such matters to ensure auditors' independence.

Notably, section 9(1) of the Companies Act reads "A person shall not knowingly consent to be appointed, and shall not knowingly act..." Observably, the term 'knowingly' has been used twice in the provision. The English court in *Secretary of State for Trade and Industry v Hart*<sup>19</sup> on an English provision which contains similar words pointed out that it is not a strict liability offence<sup>20</sup> and thus, knowledge on the part of the person charged must be proved.<sup>21</sup> This means that if a person does not know that he is disqualified under section 9(1) of the Companies Act and consents to be appointed as an auditor, he is not in breach of the provision. This provision is ironic since the person should have knowledge of whether he is disqualified by the Companies Act.

The state of knowledge should not be on the basis of actual knowledge. It should be based on constructive knowledge. This is because it will be easy for auditors to claim that they have no knowledge as the issue is based on evidence. Furthermore, auditors should be required to make a declaration that they are not disqualified under section 9(1) of the Companies Act.<sup>22</sup> In the event the auditors fail to declare or they make a false declaration, they should cease to be approved company auditors and be liable to have their license revoked. This is because they have not satisfied the requirement of being persons of good character.

Furthermore, section 9(1)(b) of the Companies Act provides that the auditor should not be indebted to the company in an amount more than RM2500. At the time the Companies Act was enacted *i.e.* 1965, the amount was considered to be high. However, in contemporary years the amount is meagre. Thus, the provision should be amended whereby the auditor should not be indebted to the company at all. This will truly reflect

<sup>18</sup> Hadden, Tom, *Company Law and Capitalisation*, 2<sup>nd</sup> ed., (London: Weidenfeld and Nicolson, 1977) at 137.

<sup>19</sup> [1982] 1 All ER 817, [1982] 1 WLR 481.

<sup>20</sup> When interpreting a similar provision in the English Companies Act.

<sup>21</sup> The Malaysian provision is in *pari materia* with the provision in England *i.e.* section 389(7) Companies Act 1985.

<sup>22</sup> This is similar to the declaration made by directors that they are not in breach of section 125(1) and section 130 'of the Companies Act.'

the independence of the auditor. There is no legal justification that an auditor who owes a company less than RM2500 is independent whereas an auditor who owes a company RM2501 is not independent. It should be noted that under section 40(4)(d) of the Banking and Financial Institutions Act 1989, an auditor should not be indebted at all to the banking and financial institution in which he is auditing. Thus, section 9(1)(b) of the Companies Act should be amended to be in line with section 40(4)(d) Banking and Financial Institutions Act 1989 to reflect the approach taken in contemporary years.

## APPOINTMENT

In order to ensure that a company's finances are properly managed and its accounts are properly kept, all companies must appoint auditors.<sup>23</sup> In fact they are compulsory fixtures of a company.<sup>24</sup>

Section 172(1) of the Companies Act provides that the directors of a company must appoint an auditor anytime before the first annual general meeting. Thus, auditors hold a statutory office.<sup>25</sup> In *Richard C Tarling v PP*<sup>26</sup> the court confirmed that it is the duty of the directors to appoint duly competent persons as auditors of a company. This is done in the interests of the company. This is because the directors rely on the auditors' report in setting the pace and direction of the company. However, it should be noted that the directors' power to appoint auditors concerns the first auditors of the company. In relation to listed companies, the duty rests with the audit committee.<sup>27</sup> The justification to empower directors to appoint an auditor is that the company has not had its first annual general meeting.<sup>28</sup> The only way to get the members to appoint an auditor

<sup>23</sup> Koh, Pearlle M C & Yeo, Victor C S, *Company Law*, (Singapore: Butterworths Asia, 1999) at 145.

<sup>24</sup> Padmanabha Rau, K V, *Company Law of Malaysia*, (Kuala Lumpur: ILBS, 2003) at 430.

<sup>25</sup> Gullick, J M, *Ranking and Spicer's Company Law*, 13<sup>th</sup> ed., (London: Butterworths, 1987) at 251.

<sup>26</sup> [1981] 1 MLJ 173.

<sup>27</sup> Part C Chapter 15 of the Bursa Saham Malaysia Bhd. Listing Rules.

<sup>28</sup> A company can call for an annual general meeting at anytime within 18 months of its incorporation – section 143 'of the Companies Act.'

is to call for an extraordinary general meeting.<sup>29</sup> Nevertheless, it will unnecessarily add to the administrative cost and inconvenience to the company.

An ambiguous issue concerning section 172(1) of the Companies Act is that it only stipulates that the auditors should be appointed at anytime before the first annual general meeting. It does not stipulate precisely when they should be appointed. Furthermore section 143 'of' the Companies Act provides that an annual general meeting could be held at anytime within 18 months of its incorporation. This means that an auditor could be appointed in the 17<sup>th</sup> month. If that is the case, the auditors may not have sufficient time to audit the company's accounts in time to report at the annual general meeting. Thus, provision should be made that auditors should be appointed within one month of a company's incorporation. This approach is similar to the approach taken under the Australian legal position as can be seen in section 327 of the Corporations Act 2001. This will enable the auditors to audit the company's accounts effectively.

Section 172(1) of the Companies Act further states that in the event the directors do not appoint an auditor, the company at the general meeting can appoint an auditor. Thus, the duty is shouldered on the shareholders too. It also shows that the appointment of the first auditors is not solely a management power. Nonetheless, the issue is that since the provision is silent as to when an auditor should be appointed, it is unclear as to when shareholders have the right to invoke this provision. This is because if the provision is silent as to when the directors should appoint an auditor, then it cannot be argued that appointment has not been made. Shareholders cannot invoke this provision since the directors have approximately 18 months. The shareholders can only invoke this provision in the 18<sup>th</sup> month. Hence, if there is a requirement that auditors should be appointed within one month of incorporation, then the shareholders can exercise their rights in the second month. The provision should read that the appointment be made in the second month of the company's incorporation.

If the company at the general meeting fails to do so, section 172(10) of the Companies Act provides that the Companies Commission of Malaysia<sup>30</sup> may do so on the written application of a member.

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<sup>29</sup> Article 44 Table A.

<sup>30</sup> Hereinafter referred as CCM.

Two matters can be observed. Firstly, although section 172(1) of the Companies Act empowers the company at a general meeting to appoint an auditor, the appointment is based on simple majority. Sometimes, there can be occasions where the members wishing to appoint auditors may not have a simple majority and thus are unable to appoint an auditor. This is especially in cases where the directors who are also shareholders may have the controlling power in the company and not appoint any auditor. In such a case, section 172(10) of the Companies Act is invoked as it allows any member to make an application to the Registrar to appoint an auditor. The member making the application can be a single member holding any number of shares in the company.

Secondly, the fact that CCM is empowered to appoint an auditor shows that the appointment of an auditor is not merely an internal matter as it involves a regulatory body. The guiding principle of the provision is that at any point of time, someone has the power to appoint auditors in a company. This shows the importance of appointing auditors in a company. In the event auditors have been appointed, section 172(2) of the Companies Act provides that after the initial appointment of the auditors, the company must appoint auditors at every annual general meeting. Thus, the appointment of the auditors is on an annual basis as can be seen in section 172(9) of the Companies Act which reads that auditors shall hold office until the conclusion of the next annual general meeting of the company. The benefit of the provision is that it provides requisite powers to the members of the company in deciding whether to reappoint the auditors. If they are satisfied with the auditors' performance, they will be reappointed.

It should be noted that there is no provision in the Companies Act that the same auditors shall be reappointed. Similarly, there is no provision in the Companies Act that the same auditors should not be reappointed. Thus, it is left to the decision of the company whether or not to reappoint the same auditors. It also shows that the decision to reappoint or not to reappoint the auditors is to be determined on an annual basis.

There are two issues on this point. On one hand, it is not a power to be exercised by the directors but by the shareholders by virtue of section 172(2) of the Companies Act. But, in practice, it is the Board of Directors who choose the auditor. Usually the same auditors are chosen by the Board of Directors. The choice will then be either approved or

rejected by the members at the general meeting.<sup>31</sup> It is usual for the members to agree with the choice made by the Board of Directors. Although, the power of appointment is in the hands of the shareholders, it is a legal fiction.<sup>32</sup> This is because members of the company may not know the suitable auditors that can be appointed. Rightfully, there should be a register open to the public containing a list of auditors who are eligible to be appointed.<sup>33</sup> Currently, there is no such register available. If there was, the shareholders could make a more informed decision when appointing auditors.

Difficult issues can also arise in cases where the auditors find that there have been irregularities practiced by the Board of Directors. In such a case, the issue is whether the auditors will bring these to the attention of the members. If they do, their reappointment as auditors will be at stake especially in cases where the directors have control over the majority votes in the company. Thus, most of the time, the auditors communicate their findings to the directors.<sup>34</sup> This is in a way less provocative and confrontational. The members will not have knowledge of the irregularities. The Board of Directors and the auditors will then come to a settlement on the best way to deal with the irregularities. Thus, it was rightly pointed out that the auditors have begun to assume the role of giving credibility to the management's financial reports.<sup>35</sup> The best way to deal with such a situation is to ensure that the appointment of auditors is not at the liberty of the Board of Directors. Provision should be introduced in the Companies Act that auditors are appointed for a year unless removed by the members. Alternatively, there should be an independent office to oversee the appointment of the auditors in large

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<sup>31</sup> McInnes, W M, *Auditing into the 21<sup>st</sup> Century*, (Scotland: Institute of the Chartered Accountants of Scotland, 1993) at 24.

<sup>32</sup> Mitchell, A, Puxty, A, Sikka, P & Willmot, H, *Accounting for Change: Proposals for Reform of Auditing and Accounting*, (London: Fabian Society, 1991).

<sup>33</sup> Similar to the position in England, see Companies Act 1989 (Register of Auditors and Information about Audit Firms) Regulations 1991 (S.I. 1991 No. 1566).

<sup>34</sup> Stephen, W Mayson, Derek, French & Christopher, L Ryan, *Company Law*, (London: Blackstone, 1999) at 564.

<sup>35</sup> Wesberry, James P Jr, "The Pursuit of Professionalism" (April 1989) 46(2) *The Internal Auditor* 24.

companies.<sup>36</sup> Alternatively, the Board of Directors should not be allowed to hold shares in the company which exceeds fifty percent. In that case, their voting power cannot be misused for their own interests.

On the other hand, the justification for a requirement of annual appointment of auditors is to ensure that the existing auditors do not view that their appointment is not indispensable. Otherwise, it would lead to complacency and auditors not performing their role and duties to the expectation of the existing individual shareholders, directors, audit committee, prospective shareholders, employees, creditors, guarantors, companies wishing to exercise takeovers and mergers, trustees, beneficiaries, regulatory bodies, government, professional bodies and members of the public.

The combined effect of section 172(1) (2) (10) of the Companies Act is to ensure that as long as a company is in existence and operational, there is a requirement of appointing auditors. It is also to ensure that the office of auditors is not vacant. The duty is either shouldered by the directors, company at the general meeting or the CCM. The appointment of auditors is, thus, crucial to the operation and continuance of a company. It was rightly pointed out by the English court in *Re Transplanters (Holding Co) Ltd*<sup>37</sup> that “once a man takes upon himself a position of an auditor...he must stand aloof and divorced from the aims, objects and activities of the company.”

## RESIGNATION

Section 172(14) of the Companies Act provides that an auditor may resign if he is not the sole auditor of the company or at a general meeting of the company, but not otherwise. This shows the importance of his presence in the company. Thus, an auditor gets ‘locked’ in a company unless there is another auditor appointed.

Nonetheless, the concern is whether the resigning auditors have done all that they ought to have done, before resigning. section 172(14)

<sup>36</sup> Humfrey, C G, Moizer, P & Turley, W S, “The Audit Expectation Gap in Britain: An Empirical Investigation,” (Summer, 1993) 23 *Accounting and Business Research* 395-411.

<sup>37</sup> [1958] 2 All ER 711.

of the Companies Act is only concerned about the fact that there must be an auditor in a company at all times. Even if a sole auditor wishes to resign, he can do so only at a general meeting. The provision does not grant him the right to make a representation, make written representations, require the company to circulate the written representation to the shareholders and require the company to read out the written representation to the shareholders at the general meeting unlike section 172(5) of the Companies Act as regards to removal of auditors. Neither does the provision require the auditor to make a resignation statement as to the reasons or cause for resignation. Thus, the shareholders of the company would be in a dilemma as to the reason for the resignation.

It is trite law that if the auditors have detected certain wrongdoings by the management, they are required to report to the shareholders. The issue is whether they will do so or rather resign. Thus, there must be a provision in the Companies Act requiring auditors who are resigning to make a resignation statement. Thus, if the auditors suspect that there is a wrongdoing but are unable to resolve the matter, they may resign too.<sup>38</sup> Even in such a case, there must be a statement to that effect.

Currently, section 172A of the Companies Act only requires a resignation statement to be given to CCM and the Stock Exchange for auditors of companies which are listed. It is not a requirement if it is a public company which is not listed or a private company. The legislature must have relaxed the rule with the belief that private companies are usually small, family oriented businesses. In the current corporate atmosphere private companies should not be viewed as small, family oriented businesses only. In fact, more and more public companies have converted to private companies merely to avoid the rigidity of the Companies Act. Thus, the resignation statement should be required in all types of companies.

Furthermore, the requirement that a resignation statement be sent to CCM and the Stock Exchange is insufficient since the bodies do not represent the interests of the existing individual shareholders, directors, audit committee, prospective shareholders, employees, creditors, guarantors, and companies wishing to exercise takeovers and mergers,

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<sup>38</sup> Keith, Gaines & John, Tillman, (June 2005) 135(1342) *Accountancy* 112.

trustees, beneficiaries, government, professional bodies and members of the public.

## REMOVAL

Section 172(4) of the Companies Act provides that an auditor of a company may be removed from office by resolution of the company at a general meeting of which special notice has been given, but not otherwise. The provision shows that the power of removing auditors is not in the hands of the directors but the members. It is intended to strengthen the auditors' position so that they are able to carry out their duties to shareholders and serve public interest by ensuring efficient use of company's assets.<sup>39</sup> On the other hand shareholders can remove the auditors if they are of the opinion that the auditors have not carried out the duties effectively. In the event auditors manage to discover the wrongdoings of the management, they need not fear being removed as the power to remove auditors before the expiration of their office is not with the directors.

However, if the directors have the majority voting power they may misuse their voting power at the general meeting at the expense of the minority shareholders for their self benefit by not removing the auditors. It is proposed that, in such cases, a single shareholder should be bestowed a statutory right to apply to the court or the CCM to remove the auditors.<sup>40</sup> In such a situation the court or the CCM will decide whether the application is based on valid reasons.

In cases where the auditors qualify the accounts, they cannot be removed except by the members. This guarantees the office of the auditors. This provision is important because if the auditors qualify the accounts, it means something is not right with regards to the company's accounts. It gives an impression that there have been wrongdoings in the company. Nevertheless, even members should not be allowed to remove

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<sup>39</sup> Farrar, J H, Furey, N E & Hannigan, B M, *Farrar's Company Law*, (London: Butterworths, 1991) at 497.

<sup>40</sup> This will be similar to the rights under section 143(4)(b) and section 150 Companies Act 1965 to apply for annual general meeting and extraordinary general meeting respectively.



the auditors in such cases. This is because it could be a situation where the wrongdoers who are in control, are the members and thus, use that control to remove the auditors. Thus, it should be a case of where the auditors should not be removed until and unless they are given a right to represent at the company's general meeting.

In relation to the power of the members to remove auditors as provided in the Companies Act, a difficult issue does arise. The issue concerns the underlying reason for members to remove auditors. If the underlying reason is that the auditors have failed to discover any wrongdoings by the management, it is not acceptable. This is because the auditors will only report at the conclusion of the annual general meeting. Auditors will not be able to report on any matter before the annual general meeting. The members must be equally fair to the auditors by giving them sufficient time *i.e.* at least until the conclusion of the annual general meeting. However, if at the annual general meeting, the members notice that the auditors have not detected any mismanagement, there is no real need to remove the auditors as the auditors' appointment is on an annual basis. The office of the auditors will automatically terminate anyway. Thus, the power to remove the auditors in such a case is artificial.

Therefore, the power to remove auditors will only be exercised in cases where the auditors have failed to discover any wrongdoings in preceding years. For instance, in the year 2000, there have been wrongdoings but were not discovered by the auditors. The shareholders have no knowledge that there have been any wrongdoings. Naturally, the auditors will be appointed for the year 2001. If during the year 2001, it was discovered that the auditors failed to detect any wrongdoings for the year 2000, the shareholders may wish to remove the auditors before the term expires. In that case the power to remove the auditors is realistic. Nonetheless, if the Board of Directors is in majority control then the power to remove auditors is not truly realistic. Thus, as proposed earlier, the Board of Directors should not be allowed to hold majority voting power in the company or alternatively even if they are allowed to hold shares, the shares should not carry voting power. Alternatively every company should only appoint a particular auditor once in five years. In that case, there will be equal opportunity given to all auditing firms as a way of encouraging fair and free competition among auditing firms.

## RIGHTS

The English court in *Newton v Birmingham Small Arms Co*<sup>41</sup> made it clear that the rights of auditors cannot be abridged nor restricted by any regulations of the company. This is to ensure that the rights are secured. The rights are unqualified and this will enable auditors to discharge their role and duties effectively.<sup>42</sup>

One of the rights of an auditor is the right to receive a copy of a special notice where there is a resolution to remove an auditor. The auditor may, within seven days of receipt of notice in writing, make representations in writing with the request that copies of the representations be sent by the company to all the members entitled to attend the meeting as provided by section 172(5)(b) of the Companies Act . The auditor also has the right to be heard at the meeting as provided by section 172(6) of the Companies Act. If an auditor qualifies the accounts, he has a right to explain the circumstances.

Giving auditors such rights necessitates a wider scope of duties. This is expected of auditors so that the granting of such rights is justified. Furthermore, in cases where auditors have managed to unearth any fraud or wrongdoing, it will benefit the members at the general meeting to have an idea of what has happened.

Furthermore, under section 172A of the Companies Act an auditor of a public company has a right to provide a resignation statement to the CCM and the Stock Exchange. The provision has assumed that the rights of existing individual shareholders, directors, audit committee, prospective shareholders, employees, creditors, guarantors, companies wishing to exercise takeovers and mergers, trustees, beneficiaries, government and members of the public are equated to the rights and interests of the CCM and the Stock Exchange. The auditors should have a right to publish their resignation statement in the media for the purpose of a wider readership. This is similar to those companies which are required to publish their financial report in the media. Furthermore, the provision requires the auditors to send the resignation statement to the CCM and the Stock Exchange. Nevertheless, the provision is silent as to what the regulatory

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<sup>41</sup> (1906) 2 Ch 378.

<sup>42</sup> Shantilal Mohanlal Shah, *Lectures on Company Law*, 17<sup>th</sup> ed., (Bombay: N M Tripathi Private Ltd, 1975) at 340.

body will do with the statement thereafter. Thus, it is proposed that the regulatory body should then publish the statement in the media for the purpose of a wider readership.

## **POWERS**

The Companies Act gives substantive powers to enable auditors to carry out their duties effectively. This is because if their hands are tied, they will not be able to uncover any wrongdoings by the management. In fact, any one who obstructs their duties is in breach of the Companies Act. Auditors have a right of access at all reasonable times to the accounting records and other records, including registers, of the company. They are entitled to obtain from any officer of the company, such information and explanations as they require as provided by section 174(4) of the Companies Act. They also have a right of access to the records of any subsidiary and may obtain information regarding a subsidiary for the purpose of reporting on group accounts as provided in section 174 (5) of the Companies Act.

Since auditors are bestowed with wide powers, the concern is whether their role is carried out effectively. Hence, a more meaningful role is expected of auditors so that the giving of such powers is justified.

## **PRIVILEGE**

Section 174A of the Companies Act provides that auditors enjoy qualified privilege in certain circumstances. They are not, in the absence of malice on their part, liable to any action for defamation at the suit of any person in respect of any statement which they make in the course of their duties as auditors, whether the statement is made orally or in writing.

The provision is a form of protection, albeit, not absolute and a privilege. It is a form of protection so that the auditors can carry out their role without fear or favour. On the same note, they are also required to carry out their powers without fear or favour. Thus, it removes the fear of being sued for statements made.

Nonetheless, it should be noted that the intention of the legislature is not to bestow absolute privilege on the auditors. If malice is found on

the part of the auditors, they could be liable for defamation. The finding of malice is a question of fact which will be based on evidence.

## CONCLUSION

Over the years, auditors carry out a pivotal role in relation to a company's financial matters. The office of an auditor should not be taken lightly. Nevertheless, the current provisions in the "Companies Act" do not truly bring about the desired results of enhancing the accountability of auditors. Furthermore, the provisions in the Companies Act which grant rights, privileges and powers to auditors to ensure accountability are not free from weaknesses. The provisions of the Companies Act in relations to the office of auditors must be re-assessed to ensure that the auditors perform a meaningful role in the current corporate atmosphere. The auditors' role must be strengthened so that it meets the expectations of the stockholders and stakeholders. Thus, key reforms must be made to the Companies Act to achieve the desired objectives.