**Important questions on Auditing and corporate governance for B.Com (Hons) 6th Sem**

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**Q 1 "An auditor is a watchdog not bloodhound". In light of this statement summarise the duties of an auditor.**

**Q 2 What point should be considered while framing system of internal check?**

**Q 3 Can the properly appointed auditor be removed before the expiry of his term? Explain this in brief.**

**Q 4 Give four example where the assesse who has to furnish along with the return of income a report on accountant in the prescribed form for claiming deductions under the income tax act 1961.**

**Q 5 Why it is important for every organisation to lay down a clear and comprehensive whistleblowing policy?**

**Q 6 How Harshad Mehta misused ready forward deals and banker's receipts to secretly divert funds in the capital market?**

**Q 7 what is the governance mechanism laid down by section 135 of the act to monitor CSR spending in companies?**

**Q 8 Fixing accountability of board of director including independent directors towards stakeholders is very important to ensure that corporate governance principles are being followed by corporates. Do you agree with the statement? What are the provisions contained in companies act 2013 to ensure this?**

**Case Study 1**

**Scenario**

You are a recently appointed audit partner in a large independent firm of accountants. You are delighted that you are now a partner and can't wait to sign off your first set of accounts. Your firm recently won an audit tender for a medium-sized family owned company, A Ltd, and the firm's managing partner has allocated the client to you. The managing partner is reasonably close to the family which owns A Ltd and you believe that this is at least part of the reason why the company decided to appoint your firm.

As is normal, you go through all the firm's new client procedures which include writing to the previous auditors and also obtaining sets of statutory accounts for the previous 3 years. When you receive the written reply from the previous auditors, you note that they have nothing to report other than any matters addressed in their audit report. This seems strange, so you quickly review the company's set of financial statements for the previous year and note that the company's audit report was qualified on the basis of non-compliance with an accounting standard. The audit report highlights that the company owns a property and advises that the directors, on cost grounds, decided not to have an FRS 16 valuation performed. The audit opinion adds that the auditor is unable to quantify the impact of this non-compliance with FRS 16. You wish that you had access to the working papers of the predecessor auditors but the relevant audit regulation was not applicable at this time.

You are considering the impact of this issue when Mr X, the Managing Partner, comes into your office. He provides you with an oral briefing on A Ltd and then asks you whether you have any queries. You inform Mr X what you have found. Mr X replies: "I do not see any problems; if the client does not believe that it is worth paying for this information then who are we to tell them otherwise: it is a family business after all. If we have to, we can adopt the same approach as the previous auditors and qualify the audit report on the same grounds."

That is when you inform him that you have doubts as to whether the audit qualification issued was appropriate in the circumstances. The previous auditors issued an "except for – disagreement with accounting treatment – due to non compliance with an accounting standard" and you believe that a "limitation of scope" opinion may have been more appropriate. You are not sure but you surmise that this may be because of the requirement that if a client places a limitation of scope on the work of the auditors which will require the auditor to issue a disclaimer of opinion, in advance of the auditors accepting that appointment, then unless the restriction is removed, the auditor should not continue in office for that particular client. Mr X replies that you should go ahead and reassess the position once the audit fieldwork has been completed by your team.

However, he adds: "Bear in mind that although the Managing Director (MD), is an acquaintance it has taken me a number of years to get him to use our firm as auditors – I do not want to do anything that would upset him unnecessarily and jeopardise our business relationship."

You are now reviewing the audit files of A Ltd for the year in question. The company has a turnover of around $18 million and is showing a profit of$2,900,000 for the year after taking account of the proposed audit adjustments. However, you notice that the directors have once again refused to obtain an FRS 16 valuation and therefore no gain or loss on revaluation is

reflected in the accounts. You realise that the lack of an FRS 16 valuation will mean that you will have to qualify your first audit opinion. Whilst this concerns you, what really worries you is the type of qualification that will be required i.e. a limitation of scope. If the extent of this limitation leads you to issue a disclaimer of opinion, then your firm would not be able to act for this client going forward unless the client changes its stance on obtaining FRS 16 valuations. Mr X will be furious if you adopt this approach.

Questions:

**What are the readily-identifiable ethical issues for your decision?**

*I. For you personally*

*II. For the audit firm*

*III. Who are the key parties who can influence, or will be affected by, your decision?*

*IV. What fundamental ethical principles for accountants are most applicable and is there an apparent conflict between them?*

*V. Is there any further information (including legal obligations) or discussion that might be relevant?*

*VI. Is there a conflict between the 'Guardian' and 'Commercial' strands of an accountant's responsibilities?.*

*VII. Based on the information available, is there scope for an imaginative solution?*

**Case 2**

Case Overview

After a 97 per cent fall in its share price over eight years, the management of PCCW Limited proposed to privatise the company by buying out the shares held by minority shareholders. In doing so, the company management, led by Richard Li Tzar-kai, allotted shares to insurance agents on condition that they would vote in favour of the resolution, thus going against the spirit of the prevailing corporate governance rules in Hong Kong. After a protracted legal battle, the courts disallowed the controversial vote. The objective of this case is to allow a discussion of issues such as corporate governance in a management-controlled company, the roles and effectiveness of different corporate governance mechanisms, the protection of minority shareholders' interests in a privatisation situation, and business ethics. PCCW: A Chequered Past Founded by Richard Li Tzar-kai, the son of Hong Kong tycoon Li Ka-shing, PCCW Limited (PCCW) is the holding company of HKT Group Holdings Limited (HKT), which operates primarily in the telecom, broadband and multimedia industries. It also has interests in the broadband sector in the United Kingdom and a property development company in Hong Kong.

In 1999, PCCW acquired highly-prized waterfront real estate from the government without a public auction. This was highly criticised by the media and other property developers.1 In 2000, the company acquired Hong Kong Telecom (HKT) for US$41 billion, marking the largest merger in Asia at the time. However, due to debt incurred during the process, intense competition in the local telecom sector and the challenge of an international joint venture with the Australian telecommunications company Telstra Corporation, the share price plunged 97 per cent from a peak adjusted price of $131.75 between 2000 and 2008. PCCW was removed from Hong Kong's benchmark Hang Seng Index in June 20082 . Richard Li attempted to sell his stake in the company in 2006. The Chinese Government thwarted this attempt by blocking the sale through its control of China Netcom, which owned a 20 per cent stake in PCCW3 . In 2008, PCCW's businesses were hit hard by the global recession. Profit slumped 20 per cent in the first half of the year4 . However, some key financial indicators, such as EBIDTA and earnings per share remained stable. After declaring a dividend of HK$0.133 per share, PCCW ended the year with a stable financial position despite the impact of the crisis. The Board of Directors As at 31 December 2009, the PCCW board comprised a total of 15 directors, including five executive directors, four non-executive directors and six independent non-executive directors. 40 per cent of the board is made up of independent non-executive directors, although the sixth independent non-executive director, Edmund Tse Sze Wing, was only appointed in September 2009. This fulfilled the minimum standards specified in both the Hong Kong Listing Rules and Hong Kong Code of Corporate Governance. PCCW requires each independent non-executive director to submit an annual written confirmation of his independence from the company.

In accordance with the Company's Articles of Association, at each annual general meeting, one third of directors are subject to retirement by rotation. Each non- executive director also has a term of three years and the maximum term of office for each non-executive director is three years5 . The Vote Buying Scandal After his attempt to sell his stake in PCCW was thwarted by the Chinese government, Richard Li began a three-year campaign to privatise the company. Since PCCW is listed on the Hong Kong Stock Exchange, the privatisation scheme

was governed by both the Companies Ordinance (CO) as well as the Code of Takeovers and Mergers (Takeovers Code). Under the headcount rule of the Companies Ordinance, if three-fourths of members vote either in person or by proxy in favour of a proposal, it is binding on all members. In other words, at least 75 per cent of the shareholders, regardless of the number of shares each shareholder owns, were required to approve the privatisation proposal6 . Under a scheme announced on 30 October 2008, Li and China Netcom offered to pay HK$15.9 billion to buy out minority shareholders. This would lift Li's stake in PCCW from 27.7 per cent to 66.7 per cent and Netcom's stake from 19.8 per cent to 33.3 per cent. Minority shareholders were offered HK$4.50 per share, representing a huge discount from the peak share price of HK$131.75 attained before the merger with HKT in 2000. However, in response to the offer, the price of PCCW shares increased from HK$2.90 on 14 October 2008 before trading of the counter was suspended to HK$3.58 on 5 November 2008 when trading resumed. At the shareholders' meeting to approve the proposal, management was accused of vote manipulation and rigging. Yet, the proposal was eventually approved with 80 per cent support7 . On receiving a complaint from the well-known HK governance activist David Webb, the Securities and Futures Commission (SFC) investigated allegations of vote buying. Investigations revealed that 1,000 share board lots were distributed to insurance agents of Fortis Insurance Company (Asia), previously owned by PCCW. The shares were given in return for the assurance that the agents would sign proxy forms to vote in favour of the proposal. This scheme was allegedly conceived by Francis Yuen,part of Richard Li's buyout group, and instructions were given to Inneo Lam, Regional Director at Fortis, to distribute the shares to 500 Fortis agents. Without these insurance agents, the buyout plan would only gain marginal support, with 903 approving and 854 opposing8 . Such a slim majority would not have met the headcount rule's requirement of 75 per cent support by number of shareholders. Initially, the Court of First Instance approved the privatisation plan.

Following the ruling, the Court of Appeals granted leave to the SFC to appeal against the verdict9 . The SFC applied to the court to veto the results of the shareholder meeting. On 11 May 2009, the Court of Appeal ruled that there was a clear manipulation of the vote and the extent of the manipulation raised doubts on the fairness of the voting results. In addition, the court said that vote manipulation is an act of dishonesty and the court could not sanction such an act. The judge made the following observation, referring to elderly minority investors who had invested in PCCW: "These people have put their life savings into it, and they've got nothing left. Look what happened - it [the stock price of PCCW] has gone down from HK$120 to nothing! It's pathetic … there's a difference between a takeover and a squeezing out10." Questions of Shareholders' Rights, Ethics and Legality The scandal raised questions about how privatisation proposals should be determined and whether the splitting of votes violates the letter or spirit of rules designed to protect minority shareholders. Many institutional investors, having invested for the short term, accepted the proposal due to the premium of the offer price over the prevailing market price. However, the Court of Appeals highlighted the plight of retail investors, saying, "These small shareholders are not realising their investment but in fact are being left behind ... I can't see it's going to do the company any good."11 Dialling for Votes: The PCCW Privatisation Scandal 102 Another important issue was that the buyout plan was drafted in a manner that would greatly benefit Richard Li and China Netcom. According to the proposal, after PCCW was privatised, Richard Li and China Netcom would be awarded a special dividend that would cover the entire cost of taking the company private, plus provide an extra HK$2.9 billion once the process was completed.12 Since management did not justify

the decision to award the special dividend to the parties making the buyout offer, one of the judges hearing the case commented that the proposal was "outrageous"13. These issues exacerbated the concerns of minority shareholders, many of whom were elderly investors who had to leave the meeting before casting their vote since it dragged on for more than 7 hours14. The evidence of vote rigging did not technically violate Hong Kong's market regulations because there were no laws against splitting shareholder votes. However, since it went against the spirit of the headcount rule, Richard Li and China Netcom had to withdraw the proposal based on the Court of Appeal judgement.

Questions :

1. What is the "agency" problem typically confronting companies like PCCW with a controlling shareholder?

2. To what extent is there a separation between shareholders, the board and management in PCCW? How might this have contributed to the near success of the privatisation plans?

3. Consider how PCCW's failed privatisation illustrates the effectiveness or ineffectiveness of key corporate governance mechanisms.

4. In major corporate transactions, such as the PCCW privatisation, different shareholders may have different interests and preferences. How should the board and regulators balance the interests of these different shareholders?

5. The privatisation of PCCW requires the approval of 75 per cent of shareholders (or their proxies) present at the shareholders' meeting. In your view, is this fair to small shareholders? How about large shareholders?

6. Did the board and management of PCCW act ethically in the privatisation attempt?