A Legal Scrutiny on the Auditors’ Role to Whistle-Blow

LOGANATHAN KRISHNAN

ABSTRACT

Auditors examine companies’ accounts and submit auditors’ reports. However, these duties augmented in recent years due to constant changes in the corporate atmosphere. Notably, many fraudulent activities and ventures were planned with the ingenious work and skill of auditors. Therefore, the guiding principles for auditors are responsibility and accountability so that auditors do not become part of the fraudulent activities. Thus, this study examines auditors’ role to whistle-blow any wrongful activities in a company. The study then examines the issues concerning auditors’ role to whistle-blow, to determine whether auditors are able to act as effective watchdogs. This is necessary due to the spate of financial scandals that occurred in Malaysia. Essentially, corporate law must ensure that the interests of shareholders and stakeholders are considered and hence the imposition of the duty on auditors to whistle-blow. Therefore, auditors must bear in mind the interests of the shareholders and stakeholders by countering the financial scandals through whistle-blowing. This can be achieved if auditors carry out their role to whistle-blow effectively. Additionally, the laws must be tightened to ensure that the duty to whistle-blow is legally realistic.

Keywords: auditors, whistle-blowing, corporate law

INTRODUCTION

This study examines auditors’ role to whistle-blow on the wrongful activities that have taken place in a company. The study then examines the legal issues, which arise as regards to the auditors’ role to whistle-blow in order to determine whether auditors are able to act as effective watchdogs.

BACKGROUND OF STUDY

In Latin, the term ‘auditor’ means ‘listening’. This suggests that auditors are dependent on the information provided by the relevant key personnel of a company in order to prepare auditors’ report on the company’s accounts. Therefore, the correctness of 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 the documents and financial information of a company. They are also required to verify a company’s accounts in detail. In order to do so, they watch, observe and report on the company’s financial affairs. Thus, audit is defined as “a skilled examination of such books, accounts and
vouchers as will enable the auditor to verify the balance sheet of a company.10 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. Thus, they are trained professionally to audit a company's accounts independently. Furthermore, they perform important advisory, reporting, investigatory, regulatory and administrative functions.11 This is what auditing means in most countries.8

Therefore, the function of auditors is more than just merely listening to the key personnel. Essentially, if auditors merely listen to the key personnel, there is a possibility of financial scandals taking place in a company.

FINANCIAL SCANDALS AND AUDITORS

In Malaysia, financial scandals have occurred due to the failure of auditors to report on the truth of the companies’ state of affairs. This are seen in cases such as Perwaja Steel, Technology Resources Industries Bhd, Cold Storage (Malaysia) Bhd, Ocean Capital Bhd, Megan Media Bhd, Southern Bank Bhd, Transmile Bhd, Oilcorp Bhd, Kenmark Industrial Co (M) Bhd, Welli Multi, Kiara Emas Asia Industries Bhd, Energo Bhd, United U-Li, Port Klang Free Zone, Nasioncom Bhd and Linear Corp Bhd.

Thus, auditors’ duties and obligations must be clarified due to the financial scandals.12 In fact, financial scandals are one of the major reasons for changes in company law.9 Nevertheless, the wrong lesson should not be learnt.9 The financial scandals showed that the auditors fell below the expected standards. In fact, if a company failed within certain months after being audited, the auditors are blamed for conducting an inferior audit.10 Thus, the most common question asked as regards to a financial scandal is, whether the auditors carried out their duties and obligations effectively.11

Conversely, a distinction should be made between audit failures and business failures. In the former situation, the blame is attached on the auditors for carrying out an inferior audit. In the latter, there are external factors attached and thus not all business failures are due to the auditors conduct. This can be seen as regards to General Motors Corp’s in the United States of America whereby the auditors of the company, Deloitte & Touche have raised substantial doubts about the company’s ability to continue operations.12 The auditors have pointed out the company’s inability to continue which is not due to the auditors’ ineffectiveness in pointing out the wrongdoings.

On the other hand, in the context of Malaysia, Transmile Group Bhd, which is company controlled by Robert Kuok, sparked of a concern regarding auditors’ duties and obligations. Accounting irregularities and fraud were discovered in the company.13 The company overstated its accounts to show it made profits of RM75 million and RM158 million for two consecutive years of 2005 and 2006 respectively. In actual fact, the company was at a net loss of RM370 million and RM126 million respectively.14 The stock dropped to RM9.55, which is the lowest in two years.15 However, the loss was not detected by Deloitte & Touche who were the auditors of the company but it was detected through a special audit by Moores Rowland as appointed by the company.16 However, Deloitte & Touche dismissed the claim that they failed to detect the accounting irregularities. Furthermore, they claimed that it is not practicable to expect audit to represent a 100 per cent check of a company’s financial well-being.17

Transmile Group was not convinced with such an answer and thus, it replaced Deloitte & Touche with Klynveld Peat Marwick Goerdeler18 which is another auditing firm.19 It should be noted that KPMG is an auditor for some of the companies owned by Robert Kuok.20 KPMG offers due diligence and corporate tax advisory services to Perlis Plantation Bhd which is a company owned by Robert Kuok. Such services fall within the purview of non-audit services. Thus, the issue is whether there is conflict of interests and whether the independence of auditors is at stake. However, auditors are free to offer non-audit services as it is not prohibited by the laws namely the Companies Act 1965 and the Capital Market and Services Act 2007. Be that as it may, the question is whether the auditors will be able to act as effective watchdogs.

In another situation, Ocean Capital Bhd, which is a retailer company in the domestic market, registered a RM3.85 million deficit in its shareholders funds for the first quarter financial results which ended on March 31, 2003.21 In fact, the company faced losses since 2000. Nonetheless, the losses were not brought to the attention of the shareholders by Deloitte & Touche who were the auditors of the company. This shows that the auditors failed to whistle-blow although they were required to do so under the laws. They have the expertise and skill to discover whether losses were suffered and yet they failed to do so. In the case involving Megan Media Holdings Bhd, it was found that there was fraudulent trading in the company.22 This is because there was a default of RM900 million of bank loan. As a result, it incurred a net loss of RM1.27 billion in the financial year which ended in April 2007.23 However, the auditors failed to report the matter to the shareholders of the company. They also did not report the matter to the regulators. This shows that they have failed in their duties to whistle-blow.

In the matter involving Bumiputra Commerce-Holdings Bhd,24 the company planned to bring a legal action against Deloitte Kassim Chan over audit work on the then Southern Bank Bhd.25 This is because there were inappropriate accounting treatment on the 2005 accounts. This was discovered by Price-
The accounts of Pasaraya Hiong Kong, as audited by Deloitte Kassim Chan were inappropriate in valuing certain derivative financial instruments, not writing down in full the collateral value and wrongly writing back specific provisions made on certain foreclosed properties relating to non-performing loans aged seven years and above and non-expensing of certain costs incurred. Furthermore, the net assets were overstated by RM160 million. Bumiputra Commerce exercised a takeover of Southern Bank. However, Bumiputra Commerce planned not to bring any action against the Board of Directors as it could not find any evidence of fraud.27

Sometimes, it could be a case where the auditors conspired with the accountants, Board of Directors or the management of the company to commit wrongdoings. In such a case, the auditors will not whistle-blow as it implicates them. This is seen in the case involving Tan Kam Sang, who is the accountant at Kiara Emas Asia Industries Bhd28 and Ravandan a/l Thangaveloo, who was a partner of Messrs Arthur Andersen & Co. They were charged for furnishing false information to the Securities Commission with regards to the status of utilisation of Kiara Emas’ rights issue proceeds29 whereby Messrs Arthur Andersen & Co. was engaged to audit Kiara Emas’ accounts. They were both charged on 13 August 2004. The false information related to the financial years which ended on 31 March 1997, 1998, 1999 and 2000 on the status of utilisation of rights issue proceeds. In actual fact RM16, 937, 739.20 of Kiara Emas’ rights issue proceeds was fully utilised by 31 December 1996 in contravention of the Securities Commission’s conditions. The case shows that the regulator will not hesitate to take an action if auditors fail to whistle-blow.

In another case, Yue Chi Kin who is a partner of Roger Yue, Tan & Associates was charged for abetting United U-Li Corp Bhd in submitting false information to Bursa Malaysia.30 The investigations conducted by Securities Commission revealed that the pre-tax profit in the annual report and the financial statements for the fiscal year which ended on December 31 2004 was inflated. He was charged under section 122B(b)(bb) read together with section 122C(c) of the Securities Industries Act 1983.31 The provision carries a fine of not exceeding RM3 million or a jail term of up to 10 years, or both.32

In another case, Deloitte Kassim Chan, was publicly reprimanded by Securities Commission for their failure to discharge due diligence responsibilities for the restructuring of Ocean Capital Berhad.33 There was also a failure to inform the Securities Commission of a material change in circumstances that would have affected the Securities Commission’s consideration.34 Furthermore, the auditors were imposed with a sanction of non-acceptance of all types of submissions under section 32 of the Securities Commission Act 199335 where Deloitte Kassim Chan acted as the reporting accountant, for a period of six months, with immediate effect.

Actions were taken against Deloitte Kassim Chan as they were the reporting accountant and the preparer of the Long-Form Accountants’ Report Pasaraya Hiong Kong Sdn Bhd36 and against Hwang-DBS in its capacity as the principal adviser for the restructuring scheme of Ocean Capital. The Securities Commission’s investigations showed that the audited accounts of Pasaraya Hiong Kong and the Long-Form Accountants’ Report submitted to the Securities Commission with regards to the proposed restructuring scheme of Ocean Capital contained false and misleading information.

As regards to fraud, 62% of listed companies are victims of economic crime.38 As regards to fraud, 62% of listed companies are affected.39 According to another study by KPMG Malaysia’s Fraud Survey Report 2009, almost half of the 175 companies surveyed experienced at least one incident of fraud.40 The survey was carried out between 2006 and 2008 and 47% of the companies disclosed that the total losses were RM63.9 million. Hence, this will affect the capital market and the market stability of the country. In fact, Bursa Malaysia de-listed 95 companies for financial problems between
January 1 2003 and July 15 2010. Thus, the issue of fraud and economic crime is not to be taken lightly.

Therefore, one of the ways to counter financial scandals is to improve on the quality of auditing services. Nonetheless, the Chief Executive Officer of Bursa Malaysia opined that the current legal, regulatory and corporate governance framework is robust and sufficient to protect the market. The view of Bursa Malaysia is not quite right as the number of financial scandals involving auditors is increasing. Thus, although the framework of corporate governance may have improved but the auditors’ duties and responsibilities are shrouded in mystery and mystique as ever. Thus, the quality of audit services must be improved in ensuring that financial scandals involving auditors do not recur.

A RENEWED APPROACH BY AUDITORS

The duties and obligations of auditors must be re-examined in reference to the purpose for which auditors serve in the Malaysian economy. The duties and obligations must be made more relevant, useful and reliable to existing individual shareholders, Board of Directors, audit committee, prospective shareholders, employees, creditors, guarantors, companies wishing to exercise takeovers and mergers, trustees, beneficiaries, regulatory bodies, government and members of the public. Furthermore, from an international perspective, the duties and obligations of auditors have been extended to make auditing to become more effective. This is so although it is not easy for auditors to assess the integrity of a company’s management.

Be that as it may, in conducting an audit, auditors are obliged to take a much stricter approach to their clients. There is also an increasing support for the view that auditors should take on a more active role. Thus, there is a clear need to depart from the metaphor that auditors are merely watchdogs, to formulate more exacting duties and obligations which is the duty to whistle-blow under the various legislations such as Companies Act 1965, Banking and Financial Institutions Act 1989, Capital Market and Services Act 2007 and the Listing Requirements.

Interestingly, this renewed approach by auditors to whistle-blow is adopted in recent cases whereby several auditing firms could not complete their audit properly as they had incomplete information and did not agree with the company’s management’s assumption on certain matters. The companies involved are Nam Fatt Corp Bhd, Patimas Computers Bhd, Mangotone Group Bhd, Wawasan TKH Holdings Bhd, Luster Industries Bhd, KKB Resources Bhd and Linear Corp Bhd. This is because the accounts of the companies were qualified by the auditors. Qualified accounts, is a form of whistle-blow, to alert the shareholders and stakeholders of the company that the accounts of the companies are not in proper order. Hence, the shareholders and stakeholders of the company can then make the right decisions in relation to the said companies.

The auditing firm Deloitte & Touche for Nam Fatt did not find enough audit evidence for doubtful debt provisions and at the same time, the audited accounts of some of the subsidiary companies were not available. As regards to Wawasan TKH Holdings Bhd, its auditing firm Binder Dijker Otte disagreed with certain assumptions made by the management of the company. One of the assumptions is that certain assets worth RM83 million should not be impaired or that the value should not fall due to the assumption on sales growth of 19 percent and gross profit margins of up to 18 percent. According to the auditors, the assumptions are difficult to be substantiated due to past actual outcomes and it is considered as an area of uncertainty. In Patimas Computers Bhd, the auditors do not agree with the company’s management that it can recover money from a former subsidiary company. In relation to Linear Corp Bhd, the company paid out almost all of its cash to a company in Seychelles. The auditors made a qualified report relating to the recoverability of certain advances made. The company advanced RM36 million to Global Investment Group Inc to build a RM 1.66 billion cooling tower in Manjung Perak and finally the amount was returned to Linear Corp Bhd.

The above cases show that the auditors are willing to point out whether the company’s accounts show a true and fair view of the company’s affairs. It also show how auditors took a more active role to whistle-blow to the shareholders of the company, by making a qualified report. The renewed approach by auditors to whistle-blow is the way forward in the context of modern auditing. However, the number of auditors who did so is meager. They do not reflect the approach taken by the auditing profession in general. Hence, the succeeding section examines whether the problem lies with the laws which govern auditors’ role to whistle-blow.

AUDITORS’ ROLE TO WHISTLE-BLOW

Auditors must adhere to a strict professional code of conduct in order to maintain the confidence of the shareholders and stakeholders. This includes the duty to whistle-blow. In the case of Winters v Houston Chronicle Pub Co the court was explaining the term whistle-blow to mean that the police being the law enforcers, would blow the whistle to alert the public that there is a danger taking place.

Thus, in the context of auditing, auditors are seen as whistle-blowers since they are required to examine the financial documents of a company and report it to the shareholders of the company. Additionally, the report is lodged with the Companies Commission of Malaysia to alert the stakeholders, on the company’s financial
position. The following section examines auditors’ duty to whistle-blow under the various statutory provisions.

THE DUTY TO WHISTLE-BLOW BREACH AND NON-OBSERVANCE UNDER THE COMPANIES ACT 1965

In section 174(8) of the Companies Act 1965,\textsuperscript{56} it provides that in carrying out auditing duties, if the auditors discover that there has been a breach of the Companies Act 1965 and it has not or will not be adequately dealt with by the auditors’ report or the directors of the company, they are bound to report to the Registrar. This shows that the auditors are required to whistle-blow to the Registrar although the term whistle-blow is not used. This is a watchdog function of the auditors.\textsuperscript{57} Nonetheless, it is more than a watchdog function as the provision requires the auditors to review the steps taken by the Board of Directors in addressing the breach. Furthermore, this provision shows that auditing company accounts is not merely an internal matter as it involves the regulator which is the Registrar.

However, the predicament is the standard expected of auditors to whistle-blow. This is because it is unclear whether it is based on what the auditors believe or whether the auditors could have reasonably discovered the breach of the Companies Act. The provision reads “…if an auditor…is satisfied…” Thus, the provision suggests that it is based on what auditors believe since it is worded subjectively.\textsuperscript{58} Notably, the duty to whistle-blow to the Registrar does not arise if the auditors do not consider that there was any breach or non-observance of the Companies Act 1965. The provision does not impose the duty to whistle-blow since the duty is determined by the auditors themselves. The provision should have incorporated the duty to whistle-blow based on objective standards. The provision should have read “…where an auditor…ought to have known that there has been a breach …”. In that situation, an objective standard is imposed on the auditors. The standard is then based on what reasonable and competent auditors would have known in the given circumstances. In that case, the duty to whistle-blow will be uniformly applied among the auditing profession.

Furthermore, the provision concerns a breach or non-observance of the Companies Act 1965. The provision is criminal in nature as the penalty on the auditors for failure to whistle-blow is an imprisonment of two years or a fine of RM30,000 or both. Thus, the issue is whether the auditor should be satisfied on the balance of probabilities or beyond reasonable doubt. Essentially, the degree of satisfaction should increase with the gravity of the imputation the auditor is making.\textsuperscript{59}

A further problem is that the provision does not stipulate who committed the breach that is whether it is the company, officer or agent of the company. Since a company is not a natural person, the breach must have been committed by the management or the directors of the company. Thus, the provision should clearly stipulate whether the breach was committed by the company, officers or the agent of the company so that auditors are clear regarding the scope of the provision. This will also enable auditors to whistle-blow effectively to the regulator.

THE DUTY TO WHISTLE-BLOW ON FRAUD AND DISHONESTY UNDER THE COMPANIES ACT 1965

In section 174(8A) of the Companies Act 1965,\textsuperscript{60} it provides that auditors of a public company are under a duty to report to the Registrar if the auditor is of the opinion that a serious offence involving fraud or dishonesty is being or has been committed against the company or the Companies Act 1965 by officers of the company. This is also a case of where auditors are required to whistle-blow as they are required to report to the Registrar.

A concern is that the duty is only imposed on auditors of a public company or a company which is controlled by a public company. Section 174(8C)(a) of the Companies Act 1965 provides that a company is considered as being controlled by a public company if the public company has not less than 15% of voting shares in that company.\textsuperscript{61} There is no legal rationale for requiring auditors to report on fraud or dishonesty only on companies where the public companies have 15% of voting shares. The public company may choose to hold 14% of voting shares to avoid this provision. Furthermore, the requirement to whistle-blow on fraud or dishonesty should not be restricted to public companies just because the public have invested their money in such a company. There could also be fraud or dishonesty in private companies which run large operations. This is because there is a growing trend of public companies being converted to private companies in recent years. Thus, the duty to whistle-blow does not apply to auditors of all companies.

Furthermore, the difficulty with this new provision is the manner the auditors will form their opinion. This is because it is worded subjectively which is “…if the auditor is of the opinion…” It will be difficult, in cases where the auditors are not of the opinion that there is any fraud or dishonesty. The provision should have been drafted to read “…the auditor is of the opinion there is fraud or dishonesty committed in the course of performance of their duties.” In such a case the auditors are under a duty to detect fraud and whistle-blow to the regulator. Moreover, the new provision does not impose a duty on the auditors to detect fraud. It only provides that [IF]\textsuperscript{62} the auditor is of the opinion that there has been a fraud or dishonesty, he is under a duty to report
to the Registrar. The emphasis is placed on the auditors’ duty to report and not duty to detect fraud. Thus, the auditors are not able to whistle-blow since in the first place there is no duty to detect fraud.

Notably, the requirement that the auditors should whistle-blow to the Registrar is insufficient since the Registrar does not represent the rights and interests of the existing individual shareholders, Board of Directors, audit committee, prospective shareholders, employees, creditors, guarantors, trustees and beneficiaries of the company, companies wishing to exercise takeover bids and mergers, the government, the relevant professional bodies and members of the public as they are affected if the auditors fail to whistle-blow as compared to the Registrar. Additionally, the Companies Act 1965 does not provide what the next course of action is on the part of the Registrar with regards to the auditors’ report. The provision does not require the Registrar to make the report public for the interests of the shareholders and stakeholders. Therefore, the auditors take this role to whistle-blow lightly.

It should also be noted that fraud and dishonesty is not specifically defined in the Companies Act 1965. Nevertheless, section 174(8C)(b) provides that a serious offence involving fraud or dishonesty means an offence that is punishable by imprisonment for a term that is not less than two years or the value of the assets derived or any loss suffered by the company, member or debenture-holder exceeds RM250,000 and includes offences under sections 364, 364A, 366 and 368 of the Companies Act 1965. Essentially, the offence involving fraud or dishonesty must be an offence as provided for under the Companies Act 1965. However, the fact that the provision uses the term “…includes…” which shows that section 174(8A) of the Companies Act is not confined to sections 364, 364A, 366 and 368 of the Companies Act 1965. It can include other types of fraud as defined in other legislations. Thus, the concern is whether auditors are able to comprehend the various types of fraud in order to carry out their role of whistle-blow effectively.

Be that as it may, making auditors’ report on the basis of the concept of ‘true and fair view’ no longer acts as a yardstick for auditors to check the accounts of a company since there is a duty to whistle-blow reposed on auditors as regards to fraud and dishonesty. Observably, the duty to whistle-blow on fraud and dishonesty is a higher duty compared to the duty to report on the company’s accounts. The duty to report on the company’s accounts is result oriented whereas the duty to whistle-blow on fraud and dishonesty is process oriented. Notably, the duty to whistle-blow on the fraud and dishonesty is only imposed on the auditors in 2007 by virtue of the amendment to the Companies Act 1965, whereas the duty was imposed on the auditors in the banking sector in 1989. It took 18 years to convince the legislature that the duty should also be imposed on the auditors in other sectors. Such a duty is essential. This is because “…corporate accounting does not do violence to the truth occasionally, and trivially, but comprehensively, systematically and universally, annually and perennially".63 Fundamentally fraud can also distort a company’s accounts.

In Newton v Birmingham Small Arms Co Ltd64 the court observed that a company’s Articles of Association cannot preclude the auditors from availing themselves of all information, required for their report. This is in accordance with the right of access to company’s financial information as provided by section 174(4) of the Companies Act 1965. Since the auditors have the right and they can exercise the right without any restriction, the provision gives the platform to the auditors to detect fraud. Thus, there is no reason why auditors find it difficult to detect fraud.

Both the provisions namely sections 174(8) and (8A) of the Companies Act 1965 uses the term ‘shall report’ which suggests that the duty to whistle-blow is owed by the auditors to the Registrar. Essentially, the Registrar represents the interests of Companies Commission of Malaysia. The duty owed by the auditors to the Registrar supersedes the duty which is owed to the company, Board of Directors and its shareholders. This further proves that the office of auditors is a public office. In fact, although the auditors are engaged by the company, ultimately, the auditors are accountable and answerable to the Registrar.65

THE DUTY TO WHISTLE-BLOW UNDER THE BANKING AND FINANCIAL INSTITUTIONS ACT 1989

In section 40(13) of the Banking and Financial Institutions Act 1989,66 it provides that Bank Negara may at any time require an auditor to submit such additional information as Bank Negara may specify; enlarge or extend the scope of his audit as Bank Negara may specify; carry out any specific examination or establish any procedure in any particular case or submit a report on any of the matter above. Bank Negara may specify the time within which the above is required. The provision shows that the auditors owe a duty to the financial institution and Bank Negara. This is because Bank Negara has a right to get involved in the financial institution’s affairs. It also shows that the duties and obligations under the Companies Act 1965 and BAFIA are not comprehensive as the duties and obligations could be extended by Bank Negara. Furthermore, the applicable accounting standards are not exhaustive as Bank Negara may impose some other procedure to be adopted by the auditors. Consequently, the auditor role to whistle-blow is also enhanced.

In section 40(15)(a) of the BAFIA, it provides that auditors of banks and financial institutions are under
a duty to report to Bank Negara if there has been any contravention of BAFIA or any offence which relates to dishonesty or fraud under any other law. The provision shows that the duty to whistle-blow is extended to reporting to Bank Negara. This provision is similar to section 174(8A) of the Companies Act 1965. However, the application of section 40(15) of the BAFIA is wider than section. 174(8A) of the Companies Act 1965 as the latter is confined to fraud and dishonesty in the context of the Companies Act 1965. This means that in relation to section 40(15) of the BAFIA, the Companies Act 1965, Capital Market and Services Act and the Penal Code will apply as the provision reads “...any other law...”. This is not found in section 174(8A) of the Companies Act 1965. Another concern is whether Bank Negara represents the interests of the shareholders and stakeholders since auditors are required to report to Bank Negara. Additionally, the provision is unclear as to what the next course of action will be on the part of Bank Negara after receiving the report.

In section 40(15)(b) of the BAFIA, it provides that an auditor shall report to Bank Negara if losses have been incurred by the financial institution which reduce its capital funds to an extent that it is no longer able to comply with the specifications of Bank Negara. By virtue of section 40(15)(c), the auditor shall report to Bank Negara if there is any irregularity which jeopardizes the interests of depositors or creditors of the financial institution. Finally, under section 40(15)(d), he must report if he is unable to confirm that the claims of depositors or creditors are covered by the assets of the financial institution.

THE DUTY TO WHISTLE-BLOW UNDER THE CAPITAL MARKET AND SERVICES ACT 2007

The duty of auditors to whistle-blow is provided in section 128(1) of the Capital Market and Services Act 2007. The provision reads that if an auditor becomes aware of any matter which in his opinion may constitute a breach of this Act; of any irregularity that may have a material effect on the company’s accounts including any irregularity that jeopardizes the funds or property of the clients of the company; that losses have been incurred by the company that it is unable to meet the minimum financial requirements as prescribed by the Act; he is unable to confirm that the claims of clients or creditors of the company are covered by the assets of the company; that an offence in connection with the business of the relevant person has been committed; or in the case of public listed company there has been a contravention of the rules of a stock exchange, the auditor shall immediately report the matter to the stock exchange and Securities Commission.

Nonetheless, the provision uses a general word which is the word ‘offence’ as opposed to ‘fraud or dishonesty’ in section 174(8A) of the Companies Act 1965 and section 40(15) BAFIA. This means that the duty of auditors to whistle-blow is not only confined to fraud and dishonesty but to any offence. This means that the duties of an auditor under the Capital Market and Services Act are wide. A further distinguishing point is the requirement of immediate. The court will face acute difficulty in determining whether the whistle-blow by the auditors is immediate. Furthermore, section 128(3) of the Capital Market and Services Act 2007 provides that the Securities Commission may at any time require the auditor to submit such additional information; extend the scope of his audit; carry out any specific examination or establish any procedure in any particular case; to submit a report on any of the matter referred above; or submit an interim report on any of the matters above.

It should be noted that the above provision is akin to those duties imposed under BAFIA. However, the auditors of a financial institution or a public company, regardless of whether it is listed are bound by the duties as specified under BAFIA and Capital Market and Services Act respectively which is in addition to those duties imposed under the Companies Act 1965.

THE DUTY TO WHISTLE-BLOW UNDER THE LISTING REQUIREMENTS

The duty to whistle-blow under the Listing Requirements only applies to auditors of public companies which are listed in Bursa Malaysia. It is to be noted that it is a requirement that public companies which are listed must have an Audit Committee. The Listing Requirements provide that auditors are required to work hand in hand with the Audit Committee. This can be seen in the Listing Requirements 15.13.1(a), (b) and (c) which state that auditors are required to review the audit plan, the system of internal controls and the auditor’s report together with the audit committee. Furthermore, Listing Requirements 15.24 requires the auditor to review a statement made by the Board of directors pursuant to 15.27(b). The provision concerns the state of internal controls of the listed issuer and reports the results thereof to the Board of Directors. Moreover, in the Listing Requirements 15.18(d), it requires an auditor to have direct communication channels with the audit committee. Sub-paragraph (f) requires an auditor, to have a meeting with the audit committee whenever deemed necessary. Hence, if in any event the auditors find that the internal controls are unsatisfactory, the auditors are required to whistle-blow this matter to the Audit Committee to enable the latter to take the necessary steps.
THE RELATIONSHIP BETWEEN WHISTLE-BLOWERS AND THE REGULATORS

As discussed earlier, the regulators namely the Companies Commission of Malaysia, Securities Commission and Bank Negara Malaysia have an interest in this matter regarding whistle-blowing. This is because the auditors are required to whistle-blow to the said bodies. Thus, the succeeding section examines the extent the regulators ensure that the auditors carry out their duty to whistle-blow effectively.

COMPANIES COMMISSION OF MALAYSIA

The Companies Commission of Malaysia was established by the enactment of the Companies Commissions of Malaysia Act 2001. The functions and powers of the Companies Commission of Malaysia are provided in Part III of the Companies Commissions of Malaysia Act. Section 17 of the Companies Commissions of Malaysia Act provides for the functions of Companies Commission of Malaysia namely to ensure that the corporate laws are administered and enforced. In fact, the approach taken by Companies Commission of Malaysia is a balanced enforcement. Thus, the Companies Commission of Malaysia does not only carry out administrative functions but it also has the powers to bring wrongdoers to trial. In order to do so, section 18 of the Companies Commissions of Malaysia Act provides that Companies Commission of Malaysia shall have the power to do all things necessary for the performance of its functions. Thus, Companies Commission of Malaysia has the power to institute proceedings against any person who has contravened the Companies Act 1965.

In ensuring that the enforcement on the auditors is effective, theCompanies Commission of Malaysia has an Investigative Division which carries out investigations on the complaints that are made to the division. The Complaints Section is responsible to accept record and act on the complaints from the company officers, shareholders or the public regarding any breaches under the Companies Act 1965. The particular unit which is responsible for the conduct of auditors is the Financial and Fraud Section. However, the division will not carry out investigation unless there has been a complaint made against an auditor. If there is a complaint and after investigation, the matter warrants further action, the division recommends the necessary action to be taken by the enforcement team. The division gives full support to the prosecution in the interests of the shareholders and stakeholders of the company in which the auditor is involved.

If investigation shows that there is evidence of contravention of the Companies Act 1965, the Legal Services brings an action against the auditors. The prosecution team will register the case in the court. The following table provides information on the number of cases carried out by the Companies Commission of Malaysia.

### TABLE 1. Number of Companies Registered in Malaysia

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<th>Local Companies</th>
<th>Foreign Companies</th>
<th>Total Number of Companies</th>
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<tbody>
<tr>
<td>Up to 31st December</td>
<td>922,675</td>
<td>4370</td>
<td>927,045</td>
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</tbody>
</table>

Based on the above table, since by virtue of section 174(1) of the Companies Act 1965 which require every company to appoint an auditor, it means that the 922,675 companies must have auditors appointed. Thus, the Companies Commission of Malaysia has the powers to monitor the conduct of these auditors by virtue of Section 17 and 18 of the Companies Commissions of Malaysia Act. If at any point of time, the Companies Commission of Malaysia believes that there has been a contravention of the Companies Act 1965, as regards to sections 174(8) and (8A) of the Companies Act 1965, it should bring an action against the auditors for failing to whistle-blow.

In ensuring that the enforcement on the auditors is effective, the Companies Commission of Malaysia has an Investigative Division which carries out investigations on the complaints that are made to the division. The Complaints Section is responsible to accept record and act on the complaints from the company officers, shareholders or the public regarding any breaches under the Companies Act 1965. The particular unit which is responsible for the conduct of auditors is the Financial and Fraud Section. However, the division will not carry out investigation unless there has been a complaint made against an auditor. If there is a complaint and after investigation, the matter warrants further action, the division recommends the necessary action to be taken by the enforcement team. The division gives full support to the prosecution in the interests of the shareholders and stakeholders of the company in which the auditor is involved.

If investigation shows that there is evidence of contravention of the Companies Act 1965, the Legal Services brings an action against the auditors. The prosecution team will register the case in the court. The following table provides information on the number of cases carried out by the Companies Commission of Malaysia.

### TABLE 2. Breakdown of Number of Complaints, Investigations and Prosecutions

<table>
<thead>
<tr>
<th>Year</th>
<th>Type of Cases</th>
<th>Number of Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>2007</td>
<td>Number of Complaints Received</td>
<td>452</td>
</tr>
<tr>
<td></td>
<td>Number of Investigations Carried Out</td>
<td>153</td>
</tr>
<tr>
<td></td>
<td>Number of Prosecutions</td>
<td>96</td>
</tr>
</tbody>
</table>
It should be noted that none of the complaints, investigations or prosecutions in the year 2007 involved auditors. This is so although there were many financial scandals involving auditors as discussed earlier. Thus, although provisions empower the Companies Commission of Malaysia to bring action, the powers were not used despite the cases involving auditors’ failure to whistle-blow.

SECURITIES COMMISSION

The Securities Commission was established in 1993 by virtue of the Securities Commission Act 1993. The functions of the Securities Commission are laid down in section 15 of the Securities Commission Act. The functions are to ensure that the provisions of the securities laws are complied with and to take all reasonable measures to maintain the confidence of investors in the securities markets by ensuring adequate protection for such investors. In order to carry out the functions, Securities Commission is given powers as provided in section 16 of the Securities Commission Act.

It has been reported that since the introduction of section 128(1) of the Capital Market and Services Act 2007 which concerns the auditors’ right to whistle-blow, Securities Commission has received over 40 reports. The reports were made by the auditors of public listed companies. Thus, auditors have begun to take their role to whistle-blow more seriously. It should be noted that the Securities Commission is empowered to carry out enforcement and investigation. This is provided in Part V of the Securities Commission Act. The following table provides information on the number of criminal actions taken against auditors.

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of Cases</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>3</td>
</tr>
<tr>
<td>2009</td>
<td>1</td>
</tr>
</tbody>
</table>

Nevertheless, the above table only provides the information for the year 2004 and 2009. There were financial scandals which involved auditors in other years especially for the year 2007 and 2008. Thus, the Securities Commission should also look into those financial scandals. Be that as it may, the Securities Commission is more proactive compared to the Companies Commission of Malaysia regarding the offences committed by auditors based on the statistics. This can be seen in the case involving Kenmark Industrial Co (M) Bhd which is a furniture maker, whereby the Securities Commission started investigations since the company collapsed. This is because the company lost RM140 million in stock market value in just a few days. In fact, the Securities Commission warned the auditors of listed companies to follow the rule of Corporate Governance Code otherwise they have to face the consequences. Meanwhile, Bursa Malaysia instructed Kenmark Industrial to appoint special auditors to probe its finances and the company appointed Messrs UHY Diong as its special auditor. Meanwhile, Kenmark Industrial will meet its receiver to determine the actual debt of the company. The investigation by the Securities Commission is expected to complete in August. The special auditors were appointed by Bursa Malaysia to find out if there were any accounting irregularities that contributed to Kenmark’s RM150 million in losses.

In another case which involved SJ Asset Management Sdn Bhd, the Securities Commission started its investigations after it stopped the company from managing new funds. The Securities Commission will determine who is really responsible. The Securities Commission appointed BDO to further examine, audit and report on SJ Asset Management’s books, accounts and records inclusive of the assets held. SJ Asset Management is a licensed fund company incorporated in 1992.

Both the cases above show that the Securities Commission took measures to investigate whether the auditors exercised their duty to whistle-blow effectively. By doing so, the regulator is sending a signal to the auditors at large to take their role seriously.

BANK NEGARA MALAYSIA

Bank Negara Malaysia was established by the enactment of Central Bank of Malaysia Act 1958. It is an Act to provide for the establishment, administration, powers and duties of Bank Negara. By virtue of Section 16A of the Central Bank of Malaysia Act, Bank Negara is empowered to report on the suspected offence by any person for an offence committed. In view of that, Bank Negara is empowered to give information of such commission to the police, the affected banking institution or the relevant body. Hence, the relevant body includes the Malaysian Institute of Accountants, the Malaysian Institute of Certified Public Accountants, the Companies Commission of Malaysia and Securities Commission. Thus, Bank Negara does not have the power to bring action against the auditors for failing to whistle-blow to Bank Negara.

It is important for Bank Negara to exercise this role due to section 40(15) of BAFIA which imposes a duty on auditors in the banking sector to whistle-blow to Bank Negara for any fraud or dishonesty. Nonetheless, the role of Bank Negara is only confined to auditors who audit banking and financial institutions. The following table provides information on the breakdown on the type of banks and financial institutions in Malaysia.

TABLE 3. Number of Criminal Actions Taken Against Auditors
TABLE 4. Number and Types of Banks in Malaysia

<table>
<thead>
<tr>
<th>Type of Banks</th>
<th>Number of Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>COMMERCIAL BANKS</td>
<td>22</td>
</tr>
<tr>
<td>ISLAMIC BANKS</td>
<td>17</td>
</tr>
<tr>
<td>INTERNATIONAL ISLAMIC BANK</td>
<td>2</td>
</tr>
<tr>
<td>INVESTMENT BANK</td>
<td>15</td>
</tr>
<tr>
<td>TOTAL NUMBER</td>
<td>56</td>
</tr>
</tbody>
</table>

Considering there are 56 banks and financial institutions, it is imperative that Bank Negara exercises its role of reporting offences against BAFIA to the relevant bodies at the appropriate time. This will enable Malaysian Institute of Accountants, the Malaysian Institute of Certified Public Accountants, Companies Commission of Malaysia or the Securities Commission to take the necessary action against auditors who fail to whistle-blow. However, the Malaysian Institute of Accountants, Malaysian Institute of Certified Public Accountants, Companies Commission of Malaysia and the Securities Commission do not have the power to bring any action against the auditors for breach of BAFIA unless there is also a breach of the By-Laws (On Professional Ethics, Conduct and Practice) (Institute’s By-Laws), the Companies Act 1965 or the Capital Market and Services Act respectively. Hence, Bank Negara must work hand in hand with Malaysian Institute of Accountants, the Malaysian Institute of Certified Public Accountants, Companies Commission of Malaysia and Securities Commission. This ensures that the banking and financial sector is well guarded and protected.

RESULTS OF INTERVIEWS – AUDITORS’ VIEWS

This study includes series of interviews which were conducted to examine the role of auditors to whistle-blow. The interviews were held with selected number of auditors throughout Malaysia. The breakdown of auditors interviewed is as follows:

TABLE 5. Number of Auditing Firms Interviewed

<table>
<thead>
<tr>
<th>No of Auditing Firms Interviewed</th>
<th>Location</th>
<th>Size of Firm</th>
</tr>
</thead>
<tbody>
<tr>
<td>3</td>
<td>Federal Territory</td>
<td>Medium Sized Firm</td>
</tr>
<tr>
<td>7</td>
<td>Sabah</td>
<td>Medium Sized Firm</td>
</tr>
<tr>
<td>2</td>
<td>Sarawak</td>
<td>Medium Sized Firm</td>
</tr>
<tr>
<td>6</td>
<td>Penang</td>
<td>Medium Sized Firm</td>
</tr>
<tr>
<td>1</td>
<td>Kedah</td>
<td>Medium Sized Firm</td>
</tr>
</tbody>
</table>

Thus, this study is based on qualitative research. Interviews refer to a form of direct communication between the interviewer and the respondent in a face-to-face meeting. This is a flexible method and has two-way method of communication whereby the interviewer can ask questions during the interview. Additionally, there is instant feedback which can give room to more questions, detail information, visual demonstration. The interviewer also has a control over the discussion and is able to cater to any unique situations. The interview is a respondent interview type whereby the interviewer directs the interview and the interviewee responds to the questions of the researcher. The interviews were in-depth in order to find out what is happening on a particular issue.

The question posed to the interviewee was regarding section 174(8A) of the Companies Act 1965, section 40(15)(a) BAFIA and section 128 of the Capital Market and Services Act 2007 which require auditors to report fraud or dishonesty or any offence under any law to the Companies Commission of Malaysia, Bank Negara and the Securities Commission respectively. The question posed was whether this duty to whistle-blow is realistic, practicable and necessary.

Some of the auditors stated this duty is not right as the auditors cannot be considered as an extension of the regulators. It is the regulators’ duty to detect fraud and the government should check whether there is fraud such as Bank Negara and Companies Commission of Malaysia. The government should carry out due diligence check.

The auditors also said that to a certain extent, auditors will not be able to detect fraud or dishonesty purposely done by the management and well planned in advance. In some cases it is a bit of a challenge. This is because the objective of the audit process is to determine whether the accounts show a true and fair view of the company’s financial affairs. It is not based on true and accurate view. Furthermore, the audit is based on sampling. In order to give a true and accurate view, the auditor will have to do a 100% sampling. This duty to detect fraud
and dishonesty is not realistic and practical because this is a criminal offence. Auditors are not trained to detect fraud. In order to do so it involves forensic audit. This means that the auditor will have to spend more time at the company to detect fraud. In such a case the cost of auditing will increase. Furthermore, some of the big auditing firms are auditing many companies. Thus, it is questionable as to whether the firms have the resources to detect fraud and dishonesty.

Some of the auditors found that the auditors should be responsible to detect and report fraud. This is because there is a very clear line between business and ethics. This is especially in cases where fraud is very clear at the very first instance. Companies Commission of Malaysia will then investigate on the fraud. The auditors should provide evidence to the Companies Commission of Malaysia.

However, sometimes, there could be fraud but the evidence is insufficient to prove that there is fraud. Hence, the auditors cannot be expected to gather evidence to substantiate their claim. The auditors do not want to go through the legal process. Thus, auditors must be very firm in their findings. It cannot be merely based on suspicions. This is because if there was no fraud, it is unlikely that the auditors will be re-appointed the following year as the company would have suspected that it must have been the auditors who have reported the matter to the Companies Commission of Malaysia or the Audit Committee. Otherwise, there is no reason why Companies Commission of Malaysia would want to investigate the company.

In some situations, the auditors will speak to the management of the company and rectify the situation. This will depend on whether the auditor is of good character. Most importantly, he should not compromise. If he is of good character, then the duty to report fraud is realistic. Essentially, one must determine first, at which level is the fraud or dishonesty is committed. If it is the subordinates, then the viable thing to do is to speak to the management who will then bring an action against the subordinates to recover the loss. However, if the loss is big and it cannot be recovered then it is advisable for the auditors to report the matter to the relevant regulators. This is even more if the fraud was committed by the management. In such a case, the auditors will not be able to report it to the management. Thus, the best thing to do will is to report to the regulators. Rightfully they should also report the matter to the shareholders of the company, but it is unlikely that the auditors will do such a thing.

On the other hand, some of the auditors found that the duty under section 174(8A) of the Companies Act 1965, section 40(15)(a) BAFIA and section 128(1) of the Capital Market and Services Act 2007 are not realistic. This is because in most cases auditors will not report fraud. The auditors are being paid by the company. If an auditor were to report fraud, the auditor will be blacklisted by the other companies and thus, the auditors will not be appointed by the other companies.

CONCLUSION
Auditors are under a duty to whistle-blow if they detect something is not right in the company. Nevertheless, if the duty to whistle-blow is not exercised, the use of a company to do business can be misused and abused. Consequently, businesses collapse and it affects the rights and interests of the shareholders and stakeholders. Since such is the magnitude on the importance of auditors, equal importance must be placed on the duties and obligations of auditors to whistle-blow. The duties and obligations of auditors to whistle-blow must be taken seriously for the sake of capital market, stability of financial and economic sector and the rights and interests of shareholders and stakeholders. There must be a renewed approach to the auditors’ duties and obligations to whistle-blow. There are lacunae in the current legal framework as the duties and obligations reposed on auditors to whistle-blow under the Companies Act 1965, BAFIA and the Capital Market and Services Act 2007 are inadequate in countering financial scandals.

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795 S.W. 2d 723, 727 (Tex 1990) Doggett, J

Hereinafter referred as the Companies Act 1965.


Emphasis added.


[1906] 2 Ch. 378.


Hereinafter referred as BAFIA.

In an Indian case of Deputy Secretary v S.N. Das Gupta an auditor of a banking company failed to verify the cash balance claimed by the management and the actual cash in hand turned out to be much less than was shown in the books. Hence, the auditor has failed to detect fraud although he was required to do so by virtue of the banking legislation in India.


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Loganathan Krishnan
Assistant Professor
Department of International Business
Faculty of Accountancy and Management
University of Tunku Abdul Rahman
Bandar Sungai Long Campus
Lot PT 21144, Jalan Sungai Long
Bandar Sungai Long
43000 Kajang
Selangor
Email: loganathan@utar.edu.my