IMPLICATION FOR AUDITORS UNDER COMPANIES ACT, 2013

Introducing 2nd Generation Corporate Governance Practices (2GCG)

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Companies Act, 2013 is a huge step forward in the history of corporate legislation. It indicates the way the governance of companies will shape in future. Replacement of the Companies Act, 1956 was on the mind of the legislature for quite some time. Several attempts were made to bring in the new Companies Act but none achieved success. Satyam fiasco was the last nail in the coffin and the Central Government became hugely serious to bring in some semblance of stricter corporate governance rules.The success was achieved in the form of passing of Companies Bill 2011 by LokSabha in 2012 and by RajyaSabha in 2013. The new Act is certainly going to change the way the companies are governed and managed. The seriousness will dawn upon the Corporate Promoters and Directors to effectively treat the companies as a separate legal entity and ensure that the interest of all stakeholders is taken care of. The focus in the new Act is on formation of independent view for the benefit of the Company and its stakeholders. Corporate Governance no longer remains restricted to creation wealth for the shareholders. The new Act ushers in second generation of Corporate Governance practices (2GCG).

Provisions relating to Auditors

When the change happens, it blows its winds and no one remain unaffected. The auditors have a dominant role to play in corporate governance. The stakeholders place their faith in the report of auditors and the underlying factor for this faith is the independence of the auditors. The auditors have come under flak after series of financial and governance scams in India and the World. The role of auditors has been questioned and it was imperative that changes be made in the Companies Act to strengthen the hands of auditors besides ensuring transparency in their functioning. This objective is sought to be achieved through major changes in the Companies Act. These changes are, however, perceived as strict and draconian by some section of auditors.

Change is always resisted

Any change in status quo always faces stiff resistance. The new era brings in some apprehensions, some confusion and some resistance. Many new provisions, which are bringing joy to the Chartered Accountants in the form of opportunities, are likely to be lost sight of in view of stricter regime favored by new Companies Act. The Chartered Accountants have to *unlearn* Companies Act, 1956 and *relearn* Companies Act, 2013. This offers huge opportunity to the youngsters who can take up practice of Corporate Law as their career choice. The Chartered Accountants will have to gear up to compete with their legal counterparts in terms of appearances before the proposed National Company Law Tribunal (NCLT). The resistance to change, in my opinion, will be temporary and fade out with the passage of time.

Term Appointment for Auditors

The new Act brings in major changes relating to appointment of auditors. The auditors will not seek their reappointment at every Annual General Meeting (AGM) of the company. Instead the

appointment of auditor will be for tenure until the conclusion of sixth Annual General Meeting. The Annual General Meeting where auditor is appointed will be treated as first Annual General Meeting. This means that auditor's appointment will now be for a period of 5 years (it could be shorter or longer depending upon when the Annual General Meetings are held) bringing in some sense of security and independence to the auditors. The tenure appointment, however, comes with a rider that at every AGM, the appointment of the auditor is to be ratified. This is minor hiccup as compared to seeking reappointment at every AGM.

Rotation of Auditors

The new Companies Act now provides for rotation of Auditors in certain class of companies. The companies include listed companies without any threshold capital limit and unlisted public companies having paid-up share capital of Rs. 10 Crores or more. Even private limited companies having paid-up share capital of Rs. 20 Crore or more will also require to rotate its auditors. Besides the threshold limit of the paid-up share capital of *all companies* having pulic borrowings from financial institutions, banks or having public deposits of Rs. 50 Crores or more will also have to rotate their auditors on the expiry of their term. Mercifully the rotation of auditors is not to be done by one-person companies (OPC) and small companies. Small companies are those companies which either have paid up share capital of not exceeding Rs. 50 Lacs or whose turnover does not exceedRs. 2 Crores. These threshold limits can be enhanced by the Central Government. The auditors face a rotation in the above mentioned class of companies. Within the fraternity, there is a lesser cheer for the provisions relating to the rotation of auditors. The auditors who have been nurturing the companies for a very long period now face the exit from such companies. Even the promoters who have built trust and faith over a particular auditor during last so many years will now have to scout for new and trusted auditors. The rotation of auditors has its own pros and cons. From the corporate governance angle, the rotation of auditor is a welcome step ushering in new era and shaking the complacencies. On the flip side, the auditors who have invested their time and effort in the companies for such a long time will not be allowed to reap benefits when the companies are aiming higher growth. However, this argument may not sustain, as the rotation of auditors will ultimately benefit all auditors.

Five year/ Ten year term for auditors

The rotation of auditors deals with replacing the auditors/ audit firm after one term/ two terms of 5 years each. The rotation of auditor will happen in the class of companies mentioned above after a period of 5 years in case the auditor is an individual and ten years in case the auditor is an audit firm. These provisions are applicable w.e.f. 1st April 2014. It has been clarified by the Ministry of Corporate Affairs (MCA) that for calculating the period of 5 consecutive years or 10 consecutive years, as the case may be, the period for which the individual or the firm has held office as auditor prior to the commencement of the new Act, the same shall be taken into account. The auditor can be re-appointed in the company only after he completes a cooling off period of 5 years, which should be continuous.

Restrictions in Appointment

The new Act disqualifies any auditor or audit firm from appointment in a company if it is associated

with the outgoing Auditor of audit firm under the *'same network'* of audit firms. The term *'same network'* includes the firms operating or functioning under the same brand name, trade name or common control. The new Act also restrains a partner who is in charge of the firm and certifies the financial statement of the company from being appointed as an auditor for next 5 years. Infact, even if he retires from the said firm and joins another firm of chartered accountants, such firm shall also be ineligible for appointment as auditor for a period of 5 years.

Interestingly the new Act mandates that the class of companies falling under the requirement of mandatory rotation of auditors must comply within 3 years from the date of commencement of the Act. In other words, the companies have been allowed a transitional period of 3 years. This means that even though an auditor has completed his tenure i.e. he has been the auditor of the company for a period of 5 years or more, he can continue to be the auditor for the transitional period as per the choice of the company. The benefit of the transitional period will not be available to any auditor if the company chooses to comply with the provisions of rotation from the wordgo. The provisions relating to rotation of auditors are revolutionary and mark the beginning of new era for which the auditors have not been used to so far. The reality is here and its acceptance will do a lot of good to the auditors.

Certificate by the Auditor

Every auditor is now required to submit a certificate indicating:

a) That he is eligible for appointment and is not disqualified for appointment under the Companies Act, 2013, Chartered Accountants Act, 1949 and the Rules and regulations made thereunder;

b) The Appointment will be as per the term provided under the Act;

c) The appointment is within the limits laid down by the Act;

d) The list of proceedings against the auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct.

There has been some confusion as to interpretation of term “professional matters of conduct”. An attempt to interpret professional matters of conduct has been made and is stated in subsequent paragraphs.

Interpretation of Professional Matters of Conduct

Under the Companies Act, 2013, a duty has been imposed on the Audit Committee/Board vide Rule 3 that “provided that while considering the appointment, the Audit Committee or the Board, as the case may be, shall have regard to any order or pending proceeding relating to professional matters of conduct against the proposed auditor before the Institute of Chartered Accountants of India or any competent authority or any Court.”

A question has arisen whether professional matters of conduct mean matters and proceedings dealing with complaints and enquiries relating to professional misconduct initiated vide the provisions of CA Act by ICAI or pending before National Financial Reporting Authority to be constituted as per Section 132 of the Companies Act, 2013, as the case may be or cases/proceedings

pending before other forums are also required to be disclosed?

The Rule 3 the Companies (Audit and Auditors) Rule, 2014 (hereinafter referred to as 'the Rules') indicates the manner and procedure of selection and appointment of auditors. While considering the appointment of auditors, the Audit Committee or the Board, as the case may be, is mandated to have regard to any order or pending proceeding relating to professional matters of conduct against the proposed auditor before the Institute of Chartered Accountants of India or any competent authority or any Court. Under Rule 4, the auditor appointed needs to submit a certificate, inter alia, that the list of proceedings against the auditor or audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate, is true and correct.

The term ***"Professional matters of conduct"*** has not been defined under the Companies Act, 2013. The Act also contemplates constituting National Financial Reporting Authority (NFRA) under section 132 and NFRA shall have, amongst others, the power to investigate, either suomotu or on a reference made to it by the Central Government, for such class of bodies corporate or persons, in such manner as may be prescribed into the matters of professional or other misconduct committed by any member or firm of chartered accountants, registered under the Chartered Accountants Act, 1949. The explanation attached to Section 132(4) of the Act, indicates that for the purposes of Section 132(4), the expression "professional or other misconduct" shall have the same meaning assigned to it under section 22 of the Chartered Accountants Act, 1949.

Before we venture into meaning of "professional or other misconduct" as section 22 of the Chartered Accountants Act, 1949, we must conclude whether the terms "professional matters of conduct" and "matters of professional or other misconduct" used in the Act convey the same meaning. The Oxford dictionary defines the word 'professional' as 'relating to or belonging to a profession'. Importing this meaning, the professional matters of conduct will ordinarily mean matters of conduct relating to a profession. The "matters of professional misconduct" also conveys the same meaning. The word 'conduct' connotes manner of behaviour and 'professional misconduct' would, therefore, mean to be behaviour in relation to a profession. There is, therefore, no perceptible difference in the meaning of two different phrases. The intent of law is the underlying factor. The purpose, which the Rules seek to achieve, is to ensure that audit committee or board should take a decision after being fully aware of the pending proceedings in relation to conduct or misconduct of auditors relating to their profession. In a sense, the audit committee or board are concerned towards professional competence of the auditors and while deciding on their appointment must consider all pending cases of professional conduct (or alleged misconduct).

'Professional misconduct' has been defined under section 22 of the Chartered Accountants Act, 1949, which reads as under: "For the purposes of this Act, the expression"professional misconduct" shall be deemed to include any act or omission specified in any of the Schedules, but nothing in this section shall be construed to limit or abridge in any way the power conferred or duty cast on the Council under sub- section (1) of section 21 to inquire into the conduct of any member of the Institute under any other circumstances."

The aforesaid clearly implies any act or omission relating to professional conduct (or misconduct) or other misconduct of a chartered accountant. Such matters can be dealt with by the Institute of

Chartered Accountants of India (ICAI) presently and by NFRA once section 132 is notified or brought into effect. In an appellate or writ proceeding, such matters could lie before the Appellate Authority constituted under the Chartered Accountants Act, 1949 or with any High Court or Supreme Court.

The result of the above discussion is that professional matters of conduct will be confined to proceedings against a chartered accountant under the Chartered Accountants Act, 1949, irrespective of their pendency at ICAI/NFRA or writ/appellate level. The criminal or civil proceedings will not fall within the meaning of phrase "professional matters of conduct". The intent of legislature is clear and unambiguous or else it would not have used the phrase 'professional matters of conduct'. The matters relating to professional conduct (or misconduct) can be dealt only by ICAI/NFRA and not by any other court. If the intent was to include all pending cases against a chartered accountant/partner of audit firm, it was open to the Parliament to use different phrase. The civil or criminal proceedings have different connotations and consequences and though they may emanate from the act of omission or commission as a chartered accountant, they cannot fall in the domain of phrase "professional matters of conduct". Under civil or criminal laws of the country, a person cannot be held guilty for 'professional misconduct', which power vests with ICAI presently and may also vest in NFRA after notification of section 132. As an extension, any competent authority or court would mean appellate authorities or appellate/writ court dealing with "professional misconduct" under the Chartered Accountants Act, 1949. In the conspectus of the above discussion, only cases falling within the First Schedule or Second Schedule of the Chartered Accountants Act, 1949 need to be stated by the auditors, whether pending before ICAI/NFRA or at any appellate or writ stage. The pending proceedings before the civil court or criminal court, not being 'professional matters of conduct', need not be stated.

Significance of 'Relative' for the Auditors

The transactions with the relative always occupy significant attention under any corporate law.Transactions with relative required disclosure as well as special permission in the form of special resolution and/or Central Government approvals. Certain transactions with relatives were prohibited. The concept of Related Parties and relatives has attained a different level under the new Companies Act. There are severe restrictions for transactions by a company with related parties. The focus of having transactions with Related Parties has always been connected with the management and governance of the Company. The auditors had largely remained untouched with the concept of 'Relative'. The new Act, however, brings in the concept of the relative for the auditor and it makes ineligible a person for appointment as an auditor of the Company if his relative:

a) Holds any security or interest in the company, its subsidiary, its holding or associate company or its co-subsidiary for more than Rs. 1 Lac;

b) Is indebted to the Company its subsidiary, its holding or associate company or its co-subsidiary in excess of Rs. 5 Lacs;

c) Has given a guarantee or provided any security to the Company its subsidiary, its holding or associate company or its co-subsidiary for amount of Rs. 2 Lacs or more.

The implication of the above provision is that now every auditor will have to keep a tab on the

financial relationship of his relatives with the company in which he is the auditor or aspires to be the auditor. Unfortunately the requirement is not one time – to be seen at the time of appointment - but the provisions mandate that as and when the auditor incurs any of the disqualifications, he shall vacate his office as auditor. In other words, the disqualification provision including the financial transaction of relatives with the company are to be checked on a continuous basis. This makes the process very complicated, difficult and impracticable for auditors to comply. In my opinion these provisions require amendment to bring in some relief to the auditors.

Auditor not to render certain services

An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company), namely:—

(a) accounting and book keeping services;

(b) internal audit;

(c) design and implementation of any financial information system;

(d) actuarial services;

(e) investment advisory services;

(f) investment banking services;

(g) rendering of outsourced financial services;

(h) management services; and

(i) any other kind of services as may be prescribed

These services do not include services rendered by the Auditor connected with taxation and corporate law. In other words, rendering of such services is not prohibited under the new Companies Act.

Conclusion

The provisions relating to auditors have large ramifications on the auditors. Auditors must embrace these provisions and take them into their stride. In long term, the provisions will prove to be fruitful for the entire fraternity. It is, however, imperative that concerns of the auditors is addressed by way of amendments or clarifications, which will go a long way in lifting the stifled spirits of the auditors. The auditing fraternity, on its part, must send out a signal of re-assurance to the stakeholders that they will remain independent and will not allow any minor irregularity to escape their attention. The last word is yet to be written on this.