

Guest blog

## **Pillars of Governance: Statutory Auditor**

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Recent amendments to the statutory framework under the Companies Act, 2013 ("**the Act**"), have cast focus on the ever-expanding statutory duties of the auditors of a company. The purpose of an audit is to enhance the degree of confidence of users of the financial statements. In this regard, Section 129 of the Act provides that the financial statements prepared by a company should

comply with three prime conditions:

1. They should give a true and fair view of the state of affairs of the company/ companies.
2. They should comply with the accounting standards notified under Section 133 of the Act.
3. They should be in the form provided in Schedule III of the Act.

The Ministry of Corporate Affairs ("MCA") has notified 39 Indian Accounting Standards (Ind AS), under Section 133 of the Act. Further, Section 143(9) of the Act provides that every auditor shall comply with the auditing standards, which are issued by the Institute of Chartered Accountants of India ("ICAI"). The ICAI has, as on date, issued 38 auditing standards, which guide auditors in carrying out their overall responsibilities.

Section 143(2) of the Act provides that the auditor shall make a report to the members of the company, on the accounts examined by him, and on the financial statements prepared in accordance with Section 129 and Schedule III of the Act. In accordance with Section 143(2), the Auditor's Report shall, after taking into account the provisions of the Act, and the applicable accounting and auditing standards, make a statement as to whether the financial statements give a true and fair view of the state of the company's affairs at the end of the financial year.

Section 143(3) of the Act prescribes the matters on which a statement should be made in the Auditor's Report, which include aspects such as whether the balance sheet/ profit & loss account are in agreement with the books of account and returns, whether the financial statements comply with the applicable accounting

standards, etc. Rule 11 of the Companies (Audit and Auditors) Rules, 2014 (“**Audit Rules**”), prescribes additional matters on which the views and comments of the auditors should be included in the Auditor’s Report, and includes aspects such as whether the financial statements disclose the impact of pending litigations on the financial position of the company.

### **Expanding statutory duties of auditors**

Recent amendments to the Act, the Audit Rules and the notification of the Companies (Auditor’s Report) Order, 2020 (“CARO 2020”), have significantly increased the statutory responsibilities of auditors, by prescribing additional matters on which a statement should be made by the auditor in the Auditor’s Report.

#### Section 143(12) – Reporting of fraud:

Section 143(12), read with Rule 13 of the Audit Rules, provides that if the auditor of the company, in the course of performance of his duties as an auditor, has reason to believe that an offence of fraud, which involves or is expected to involve individually an amount exceeding Rs. 1 crore is being or has been committed against the company by its officers or employees, the auditor shall report the matter to the Central Government.

#### Section 197(16) – Certification of the managerial remuneration paid by the company:

Section 197(16) of the Act, as inserted vide the Companies (Amendment) Act, 2017, provides that the Auditor’s Report shall make a statement as to whether the remuneration paid by the company to its directors is in accordance with the provisions of Section 197, and whether remuneration paid to any director exceeds the limit prescribed under Section 197.

#### Amendments made to the Audit Rules:

On March 24, 2021, the MCA notified the Companies (Audit and Auditors) Amendment Rules, 2021 (“**Audit Amendment Rules**”), which amended Rule 11 of the Audit Rules, to prescribe additional matters that should be included in the Auditor’s Report.

Rule 11(f) of the Audit Rules (as inserted *vide* the Audit Amendment Rules) provides that the auditor’s report shall include the views and comments of the auditor on whether the dividend declared or paid during the year is in compliance with Section 123 of the Act. Further, Rule 11(g) provides that the auditor’s report shall also include a statement on whether the company, for financial years commencing on or after April 1, 2022, has used such accounting software for

maintaining its books of account, which has a feature of recording audit trail facility and the same has been operated throughout the year for all transactions recorded in the software, and:

- (i) the audit trail has not been tampered with;
- (ii) the audit trail has been preserved as per statutory requirements for record retention.

CARO 2020:

CARO 2020, which is applicable w.e.f. April 1, 2021, has also imposed multiple new obligations on auditors, which were absent in the Companies (Auditor's Report) Order, 2016 ("**CARO 2016**"). Rule 3 of CARO 2020 has enumerated multiple matters relating to compliance with the Act, which should be covered in the CARO 2020 Report. The matters relating to compliance with the Act include:

1. Whether inter-corporate loans comply with Sections 185 and 186 of the Act, and whether grant of such loans, security, etc., is prejudicial to the company's interest, etc.
2. Whether related party transactions comply with Sections 177 and 188 of the Act.
3. With respect to deposits/ deemed deposits, whether Sections 73 to 76 of the Act and the RBI Directives have been complied with.
4. Whether private placement or preferential allotment of securities has complied with Sections 42 and 62 of the Act.
5. Whether the unspent CSR funds, for a financial year, are transferred to the Schedule VII Fund or the Unspent CSR Account, pursuant to Sections 135(5) and 135(6) of the Act.
6. Whether any fraud by the company has been noticed, and whether any Report has been filed pursuant to Section 143(12) of the Act.

Along with certifying compliance with various provisions of the Act, CARO 2020 also requires the auditor to certify on issues arising under other statutes, such as whether any proceedings have been initiated or are pending against the company for holding benami property under the Benami Transactions (Prohibition) Act, 1988, and if yes, whether the company has appropriately disclosed the details in its financial statements.

**Increasing risks for auditors**

The increase in the statutory duties of auditors has consequentially increased the risks associated with the audit profession, as auditors can now be penalised for failure to detect fraud, and for non-compliance with statutory provisions. The

scrutiny on auditors has significantly increased with the constitution of the National Financial Reporting Authority (“NFRA”) under Section 132 of the Act, w.e.f. October 1, 2018.

Section 132(4) of the Act confers the NFRA with wide powers to investigate professional and other misconduct of auditors, and allows for the imposition of stringent penalties - which include the power to debar an auditor or an audit firm from undertaking any audit for up to a period of ten years. The NFRA has already invoked the power conferred by Section 132(4), to order the debarment of the statutory auditors of IL&FS Financial Services Limited, for professional misconduct.

These recent developments highlight the skewed risk-reward relationship for auditors. While the recent statutory amendments have disproportionately increased the risks borne by auditors, the remuneration provided to auditors continues to be frugal. The skewed risk-reward relationship reduces the incentive for an auditor to conduct a comprehensive review of a company’s affairs, in accordance with the statutory mandate.

The Supreme Court, in **S. Sukumar v. the Secretary, ICAI**<sup>1</sup> acknowledged the importance of the auditing profession, and highlighted the need for a regulatory framework to maintain oversight of the auditing profession, that is similar to the framework under the Sarbanes-Oxley Act, 2002, and the Dodd Frank Act, 2010, of the US.

In this context, a Consultation Paper issued by the MCA on February 6, 2020, had sought public comments on development of a ‘**Composite Audit Quality Index**’, for improving accountability of auditors and audit firms.<sup>2</sup> The MCA proposed that this Index shall consist of quantitative and qualitative measures for determining audit quality, and may be made mandatory for listed companies, and voluntary for other classes of companies. However, there has been no further progress on the proposals made in the Consultation Paper.

### **Coming to Cross-Roads**

Recently, auditors have been facing the brunt of enabling corporate frauds and are often penalised heavily. In **ICAI v. Mukesh Gang**<sup>3</sup>, the Hyderabad High Court

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<sup>1</sup> (2018) 14 SCC 360.

<sup>2</sup> Ministry of Corporate Affairs, Govt. of India, Consultation Paper to examine the existing provisions of law and make suitable amendments therein to enhance audit independence and accountability, February 6, 2020.

<sup>3</sup> 2016 (6) ALT 606.

held the auditors guilty of gross negligence and violation of auditing standards. It was held that if such grave professional misconduct, which affect the confidence of the public, is not dealt with sternly, it would encourage others to indulge in similar acts, and completely erode public faith in the impartiality and integrity of the ICAI members. As a result, the auditor was suspended from practice for a period of three years.

The level of strictness with which auditors are penalised for wrong-doings, such as in *Mukesh Gang* case, is in stark contrast with decisions in earlier cases, such as in ***Union of India v. M.N. Basu***<sup>4</sup>, where the Calcutta High Court had acknowledged that non-reporting of extending loan without passing a resolution under Section 370 of the Companies Act, 1956, by the auditors was not due to gross negligence but due to an erroneous interpretation of law.

The previous proposition of an auditor being a '*watchdog and not a bloodhound*' in the landmark case of ***Re Kingston Cotton Mills***<sup>5</sup> has started becoming outdated with the recent changes in the legal framework governing auditors. The ever-increasing duties of auditors, coupled with the costs borne by them in cases of default has resulted in high-level anxiety amongst the professionals in the field. The cautious approach being adopted by auditors in accepting audit matters is testament to the same.

There has also been a sharp increase in the resignation of the auditors. As the regulatory sight on auditors have become sharper, [many auditors have started resigning, owing to the associated reputational risks](#). According to data from nseinfobase.com, the mid-term cessation of auditors in NSE listed companies for the [first six months of FY 2019-20 had reached an all-time high of 35](#). The recent spotlight on auditors have also led to reluctance among Chartered Accountants in joining the audit profession.

Given that shareholders and the public rely on financial statements for checking the financial health of a company, the implications of such statements, which are signed by the auditors are far-reaching. During the course of the audit, there may be cross-roads wherein the auditor may have to take a final call on an issue, which needs an application or interpretation of law. Often, auditors in such cross-roads resort to lawyers for taking legal opinions. Attempts are made by auditors to transfer the risks in the positions they have taken. As expected, the legal fraternity has resisted such attempts. The auditor should rather focus on

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<sup>4</sup> 1963 (6) FLR 153.

<sup>5</sup> (1896) 2 Ch 279 at 288, UK Court of Appeal.

improving the audit quality and raise the bar. Stakeholders have many expectations and rely on the auditor's report in making their financial decisions. It would be unwise to let them down.

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*This blog was first published by Cyril Amarchand Mangaldas under the title **Gatekeepers of governance – Nomination and remuneration committee**. You can read the original blog [here](#) or by typing this url: <https://corporate.cyrilamarchandblogs.com/2022/12/gatekeepers-of-governance-nomination-and-remuneration-committee/>*

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- 2. Pillars of governance: Audit committee*
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