Impact of the Companies Act, 2013 – *Independent Auditors' Role and Responsibilities*

The wide ranging changes brought in through the Companies Act 2013 and the Rules made thereunder to the manner of functioning of the companies in India indicate the proactiveness of the Government towards protecting the interests of the various stakeholders by means of provisions aimed at ensuring greater discipline, ethics and accountability in the working of the various components of the framework of corporate governance of a company, including, Board of Directors, Audit Committees, Auditors, Internal Auditors, etc. The independent auditors (also commonly known as "statutory auditors" and hereinafter referred to as "auditors") are an integral part of the corporate governance framework. From their traditional role as experts who provide comfort on the truth and fairness of the financial information generated by a company, the stakeholders are looking up at the contemporary auditors to contribute more in terms of bolstering transparency, ethics and discipline in the corporates.

CA. Abhijit Bandyopadhyay

(The author is a member of the Institute. He can be reached at babhijit@icai.org)

The New Reporting Requirements

Chapter X of the Companies Act 2013 and the Companies (Audit and Auditors) Rules, 2014 notified thereunder, contain comprehensive provisions relating to appointment, qualifications, powers, duties and responsibilities, *etc.*, of the auditors.

Among the various responsibilities of the auditors are the specific matters that the auditors need to report on in terms of Section 143 of the Companies Act, 2013.

Reporting on True & Fair View of Financial Statements – Section 143(2)

The primary responsibility of an auditor is to express an opinion on the *"true and fair view"* of the financial statements of the company. Section 143(2) of the Companies Act 2013 ("2013 Act"), like section 227 of the Companies Act, 1956 ("1956 Act"), requires the auditors to make a report to the members of the company on the accounts examined by him and on every financial statement which are required to be laid before at the general meeting of the company. Though always implicit and prerequisite for the auditors, Section 143(2) now requires the auditors to explicitly report whether he has taken into account the provisions of the said Act, the accounting and auditing standards and matters which are required to be included under the provisions of the Act or related rules or Order made under Section 143(11) of the Act before expressing his opinion on the true and fair view of the financial statements. Another important change *vis-a-vis* the corresponding Section of 1956 Act is that the requirements to express an opinion on true and fair view is not restricted to just the balance sheet, profit & loss account and the cash flow for the year. The 2013 Act has left it open ended by including the phrase "and such other matters as may be prescribed" at the end although no further matters seem to have been prescribed till now in respect of Section 143(2) in the aforementioned Rules.

Auditor to specifically report that he has taken into account the provisions of the Act, Accounting & Auditing Standards etc. before expressing on opinion on true and fair view.

Other Matters to be Reported in Auditor's Report under Section 143(3)

Moving further, Section 143(3) of the 2013 Act lays out some more matters to be included in the auditor's report.While some of these matters are similar to those that the auditors had to report in terms of Section 227(3) of the 1956 Act though with some changes and quite a few have been newly added. For example, while reporting on whether the auditor has obtained all the information and explanation necessary for his audit as under the 1956 Act, the auditor has to now also specifically report that he had "sought" such information and explanation and in case that is not so, the details and impact thereof on the financial statements. Similarly, instead of reporting the observations or comments of the auditors which have an adverse effect on the functioning of the company, the 2013 Act requires the auditors to report their observations and comments on financial transactions or matters which have an adverse effect on the functioning of the company. However, the requirement to use thick type or italics is no longer there. The auditors are also now required to report any qualification, reservation or adverse remark relating to maintenance of accounts and other matters connected therewith. The 2013 Act has done away with the requirement of reporting on cess (as under Section 441A of the Companies Act 1956). However, the most important reporting requirement that has been added by the 2013 Act is that to report whether the company has an adequate internal financial controls (IFCs) system in place and the operating effectiveness of such controls.

Many reporting requirements of Section 227(3) of the 1956 Act retained (with some modifications). New reporting requirements include observations on maintenance of accounts and other related matters and internal financial controls.

Reporting Requirements Introduced through the Rules

In addition to above, three further reporting requirements have been added to Section 143(3) through the related Rules. These are whether the company has disclosed impact, if any, of pending litigations on its financial position in its financial statements, whether the company has made provisions, as required under any law/accounting standards for material foreseeable losses on long term contracts including derivative contracts and whether there has been

any delay in transferring the required amounts to the Investor Education and Protection Fund. Again, there are certain aspects in these reporting requirements which need to be clarified, such as, what would be the practical limitations of reporting under "any law" *vis-a-vis* the principles enunciated in the SA 250, *Consideration of Laws and Regulations in An Audit of Financial Statements*.

Rules additionally require reporting on pending litigations, provision for material foreseeable losses and transfers to IEPF.

IFC makes its maiden appearance in Section 135(5) that also defines the concept.

Reporting on Frauds to Central Government

The most demanding reporting requirement introduced by the 2013 Act is, perhaps, Section 143(12) which envisages the auditor to act as a whistleblower. The section requires that if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government. The time and manner of such reporting has been prescribed under the aforesaid Rules.

Since the auditor occupies a very unique position in the entire framework of functioning of a Company and the auditor's report is considered to be his mouthpiece, it is not surprising to see that this medium is sought to be used by the Central Government fruitfully for the benefit of the society. There are, however, certain issues that need to be addressed in these reporting requirements to enable the auditors to appropriately meet the expectations of the requirements of the Act and comply with them in letter and spirit. These issues have been briefly discussed in the following paragraphs.

Internal Financial Controls–*Issues for Auditors*

The Concept

The term IFCs has been introduced for the first time in the Companies Act. In the 2013 Act, it first makes an appearance in Section 134(5) that deals with the Directors' Responsibility Statement. Clause (e) of Section 134(5) requires the directors of a listed company to state in the Directors Responsibility Statement that they had laid down internal financial controls to be followed by the company and that such controls are adequate and were operating effectively. The Explanation to clause (e) describes "IFCs" as *"the policies and procedures adopted by the company for ensuring the orderly and efficient conduct of its business, including adherence to company's policies, the safeguarding of its assets, the prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information."*

Section 134(5) vis-a-vis Unlisted Companies

Section 135(5) applies only to listed companies which gives rise to a peculiar situation in case of unlisted companies where the auditors would be expected to opine on matters of a company for which even the Directors have not taken the responsibility. This is contrary to the concept of basic premise on which an audit is conducted, as enshrined in Standard on Auditing (SA) 210, *Agreeing the Terms of Audit Engagement*. The basic premise is acknowledgement by the management of its responsibility in relation to matters including design, implementation and effective operation of a system on internal controls.

Benchmark Framework for Evaluating IFCs

Even if one were to argue that establishment of such internal controls is a fundamental duty of the Directors of any company whether or not stated so explicitly in the Act, the second issue is that there is no generally recognised and accepted framework of internal controls to serve as a benchmark for evaluating IFCs in a company. While a few bigger companies in India could be using the COSO framework, it cannot *per se* be said to be "generally recognised and accepted" as there are a number of other frameworks too in vogue. Thus, it is necessary to first have such a benchmark framework before the auditors can report on IFCs. As a corollary, the Government needs to work on developing this Framework and deciding its legal mandate as

also its suitability to companies of all sizes and in various industries.

IFCs vis-a-vis Internal Control Evaluation Under Auditing Standards

Even if there is a benchmark internal control framework, while carrying out an audit of financial statements in accordance with the SAs, the auditors undertake evaluation of internal controls in relation to such matters as are relevant to forming an opinion on the financial statements. This has been clearly mentioned in paragraph A1 of SA 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing*, which further states that where the auditor is required to provide opinions on other specific matters, such as the effectiveness of internal controls, auditors would need to undertake additional procedures. Consequently, the auditor's responsibility paragraph as prescribed in the SA 700, *The Auditor's Report on Financial Statements*, contains a clear disclaimer to that effect. Further, this is a globally accepted position, and appears in the International Standards on Auditing. Even for reporting on certain internal control related clauses under the Companies (Auditor's Report) Order, 2003 (CARO 2003), the same is restricted to reporting on the aspects of existence and adequacy only and not on operating effectiveness of those controls.

Reporting on IFCs would require procedures beyond those envisaged in SAs.

Reporting on Orderly and Efficient Conduct of Business - *IFCs vis-a-vis PCAOB's[1] Auditing Standard (AS) 5*

In fact, the Auditing Standard (AS) 5, *An Audit of Internal Control Over Financial Reporting That Is Integrated with An Audit of Financial Statements* issued by the PCAOB, as the name makes it clear, deal only with such controls which deal with the entity's financial reporting process and does not extend to policies and procedures that ensure orderly and efficient conduct of its business as envisaged in the meaning of IFCs as envisaged in 2013 Act. Reporting on whether the policies have ensured "orderly and efficient conduct of the company's business" is quite subjective and beyond the scope of evaluation by auditors. If at all, this aspect is to be reported upon by the auditor, the auditors' nature and extent of procedures would be greatly different and penetrative from those employed for a normal audit of financial statements, as they would also need to address the "propriety" issues. Though ICAI could develop guidance on this aspect also, this may lead to resistance from the Company's management as it would in effect lead to a situation of the auditor sitting on judgment of the decisions of the management with an obvious benefit of "hindsight". This is neither practical nor a desirable situation. From another perspective, it would shift the burden of good governance from the shoulders of the Board of Directors to that of the auditors.

Is it possible for the auditors to report on subjective matters such as "orderly & efficient conduct of business" as part of reporting on IFCs.

The instant impact of such reporting by the auditor on the securities' prices of listed companies should also be kept in mind. Further, a clean report on such aspects by the auditors is fraught with the risk that the lay users would assume it to be a guarantee by the auditor as to the manner in which the affairs of the company are being conducted. This is contrary to the basic principles on which an audit is conducted. The liability that the auditor would incur in case of any subsequent detection of improper conduct of affairs of the Company also needs to be clarified before the auditor is made to report on this aspect. Accordingly, while reporting on IFCs, it needs to be examined if it is reasonable to assume that the evaluation and assessment by the auditors would be restricted to the extent such controls relate to preparation and presentation of financial statements.

Timing of Reporting – 'As on Date' or 'For the Period'

The timing of reporting on IFCs is also an issue that needs clarity, ie whether the reporting on the operating effectiveness of the internal financial controls would be *"as on date"* or *"for the period"* since the manner of reporting in both the situations would be different. Some deficiency/ies is/are bound to exist in any control system at any given point in time. Managements perpetually

[1] *Public Company Accounting Oversight Board, USA.*

undertake the process of identifying and rectifying deficiencies and implementing other remedial measures to strengthen the controls. Further, there seems to be no value addition by reporting on such deficiencies which have been rectified by the management and do not exist on the reporting date. Also, clause 57(k) of the Statement on CARO 2003 issued by ICAI does not require any reporting by the auditor in case of major weakness in the internal control that have been rectified by the management by the balance sheet date. Thus, it seems reasonable that the auditor's testing of the operating effectiveness of a control spans over the year but the reporting is restricted to the status "as on date". Accordingly, the auditor need not report any deficiencies found during testing of operating effectiveness which have been duly rectified by the management as at the end of the reporting period. Such deficiencies may be communicated by the auditor to those charged with governance by way of a separate report.

For better value, testing could be for the period and the report as on date.

Impact on True and Fair View

The auditors would also need to assess whether their negative observations with respect to IFCs would have an impact on the true and fair view of the financial statements. The answer to this would depend on factors such as the nature of deficiency, materiality of deficiency, mitigating factors, nature of financial statements, *etc.*, that give rise to a situation where the modified opinion has been given on the operating effectiveness of the internal financial controls. Thus, in accordance with the SAs, the auditor would need to perform adequate substantive or other audit procedures to obtain sufficient appropriate audit evidence about the amounts and the disclosures in the financial statement that would mitigate the effect of the control deficiencies which may give rise to the risk of material misstatement of financial statements. The results of the findings arising from such audit procedures would need to be evaluated in determining the nature of the auditor's opinion on the financial statements.

Reporting by Auditors of Group Financial Statements

Reporting on IFCs would pose practical difficulties to auditors of group financial statements on account of the fact that the consolidated financial statements would integrate the financial statements of the various components on which their\respective auditors would have issued their reports. In case the component is an Indian company, the auditor thereof would have included his/her report on Section 143(3)(i) of the Companies Act, 2013. In case the component is not an Indian company, there may not be any requirement for its auditor to report on internal financial controls. In any case, the components can be spread far and wide, geographically, and the management of each component could have instituted different types of internal financial controls to suit their individual requirements. Accordingly, while the consolidation under the Accounting Standard (AS) 21, Consolidated Financial Statements, is only a line by line consolidation, the same cannot be stated in respect of "internal financial controls" relating to various components. Further, Rule 8 of the Companies (Accounts) Rules, 2014 states that the Board Report, which includes the Directors' Responsibility on internal financial controls, is required to be prepared only based on the stand alone financial statements and, thus, the responsibility for establishing such controls on the subsidiaries, joint ventures and associates, in any case, woulsd not rest with the Board of the parent company but with the management of the respective component.

AS 21 like line-by-line consolidation of components auditors report on components' IFC is not possible. How will the group auditor report on IFC in audit report on group financial statements?

Applicability to Foreign Companies

Similarly, since Section 143(3) of the Companies Act 2013 applies equally to foreign companies, auditing and reporting on "internal financial controls" in a foreign company may pose typical challenges as given the Information Technology available today, in quite a few cases, "internal financial controls" may be situate and/or controlled from foreign locations.

Section 143(3)(i) vis-a-vis Section 404 of Sarbanes Oxley Act 2002 of USA

The requirement to report on IFCs and their operating effectiveness seems to be a take-off from the famous Section 404 of the Sarbanes Oxley Act 2002 in vogue in the USA which requires the auditors to report on operating effectiveness of the internal controls over financial reporting (ICFR). Interestingly, pursuant to the passing of the Dodd Frank Wall Street Reform and Consumer Protection Act, 2010, operation of Section 404 of the Sarbanes Oxley Act 2002 has been relaxed in respect of certain types of listed companies to provide that the auditors of such companies are not required to report on the internal controls. This exemption has been granted primarily in view of the increasing costs of compliance without commensurate additional benefits. However, the managements of such companies continue to report on their responsibility and their assessment of the operating effectiveness of the internal controls as envisaged under clause (a) of Section 404 of the 2002 Act. Thus, as of today, in the USA, the auditors of unlisted companies (non filers) and defined listed companies (non accelerated filers) are outside the purview of reporting on operating effectiveness of internal controls under Section 404(b) of the Sarbanes Oxley Act 2002.

In the USA, auditors of unlisted companies/small listed companies not required to report on internal controls over financial reporting.

Cost of Compliance

As mentioned earlier, the Act is silent on the responsibility of the management of the unlisted companies on defining and implementing the framework for internal financial control. However, the auditors are mandated to report on the IFCs of all companies. It goes without saying that there would be defined requirements of the auditors for reporting on IFCs and such requirements would necessarily have to be provided by the management. To ensure correct reporting by auditors, the management has to ensure a system which complies with an effective internal control mechanism. Since the reporting requirement applies to all companies, it may be burden on cost to the small and medium sized companies.

Reporting on Frauds to Central Government–*Issues for Auditors*

Fraud Definition and Considerations under SA 240

A mentioned earlier, Section 143(12) is one of the most demanding reporting requirements for the auditors. It envisages reporting of frauds by the auditor during the course of his audit. While the auditors conducting an audit of financial statements in accordance with the SAs need to comply with the requirements of SA 240, *Auditor's Responsibilities relating to Fraud in An Audit of Financial Statements*, the Standard is clear that although fraud is a broad legal concept, for the purposes of the SAs, the auditor is concerned with fraud that causes a material misstatement in the financial statements *viz.*, fraudulent financial reporting and misappropriation of assets. Further, although the auditor may suspect or, in rare cases, identify the occurrence of fraud, the auditor does not make legal determinations of whether fraud has actually occurred. SA 240 defines "fraud" as *"an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage."* Thus, the principles enunciated under SAs are from the perspective of an audit of financial statements and not from the perspective of carrying out an investigation. As a corollary, the auditor's consideration of fraud under SAs is also from the point of view of aspects relevant to audit of financial statements and its objective of expressing an opinion on the true and fair view and not with the objective of carrying out an investigation.

Definition of Fraud under Section 447 of Companies Act 2013

The primary difficulty in reporting under Section 143(12) is the wide difference in the definition of fraud as given in SA 240 *vis-a-vis* that given under Section 447 of the Act. The latter defines fraud in relation

"Fraud" under section 447 of Companies Act 2013 travels beyond financial matters; much beyond that envisaged in SAs.

to affairs of a company or any body corporate, as including *"any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss".* Clearly "fraud" under Section 447 is not restricted to misstatements in the financial statements but seems to venture into the territory of propriety or even morality since the impact is not restricted to merely wrongful gain/loss. The latter are the areas in respect of which the auditors cannot reasonably be expected to report. Also the definition under Section 447 is open ended to the extent that the aggrieved party need not just be the company or its shareholders or its creditors but extends to "any person".

Reporting on Frauds by Auditors–*An International Perspective*

To make it really effective and implementable, the scope of the auditor's work as whistleblower has to be specific and within some boundaries. Some developing countries like Australia and the USA contain similar provisions envisaging the auditor to act as a whistleblower. Specifically, in Australia, the Corporations Act 2001 (s311 and s601HG) require the auditor to report to the Australian Securities and Investments Commission (ASIC) matters that they have reasonable grounds to suspect amount to a significant contravention of the Corporations Act or, in the case of matters that are not a significant contravention, the auditor believes that the matter will not be adequately dealt with. Similarly, in USA, the Final Rule on Implementation of the Whistleblower Provisions of Section 21F of the Securities Exchange Act of 1934 issued by the Securities and Exchange Commission (SEC) states that external auditors of non-issuers not subject to Section 10A (such a broker dealers and investment advisors) may report directly to the SEC in circumstances where:

Requirement for the auditors to act as whistleblowers exist in USA and Australia, but with necessary safeguards and clear scope of reporting.

- the auditor has "a reasonable basis to believe" that disclosure is necessary to prevent the client entity from "engaging in conduct that is likely to cause substantial injury to the financial interest or property of the entity or investors"; or
- the auditor "has a reasonable basis to believe that the relevant entity is engaging in conduct that will impede an investigation of the misconduct", or
- 120 days or more have passed since the auditor-whistleblower provided the information to the relevant entity's audit committee, chief legal officer, chief compliance officer (or their equivalents), or the whistleblower's supervisor, or since the whistleblower received the information under circumstances indicating any of these parties "was already aware of the information."

In any case, a successful whistleblower mechanism needs the support of an adequate and authoritative mechanism that protects the whistleblower against cases of defamation and more importantly, against bodily harm.

Reporting on Frauds and Materiality Considerations

Also, the 2013 Act and the related Rules are silent as to the application of materiality to such fraud reporting. This could be implied to mean that the concept of "materiality" would apply in this case also as is, normally, applied in the case of audit of financial statements as per SAs. Alternatively, it could mean that all frauds, irrespective of the amount involved, would need to be reported. However, having regard to the practicality and feasibility, the former view seems to be more rational and reasonable.

What Constitutes "Reason to Believe"

Similarly, what constitutes "reason to believe" also needs interpretation. A study of some relevant international literature shows that a "reasonable ground" includes suspicion and belief and "requires existence of facts which are sufficient to induce that state in a reasonable person."In any case, it seems that the auditors would now need to add more rigor to procedures relating to obtaining an understanding of the client entity as also in exercise of professional skepticism during audit, running the risk of

bordering on "presumptive suspicion" to be able to report pursuant to Section 143(12). The same would be true in case of audit documentation also. In fact, whether the auditors would need to apply some additional procedures for reporting under Section 143(12), needs a serious contemplation.

Reputation Risk Associated with Fraud Reporting

While Section 143(12) can be an early warning mechanism, all should also be wary of the fact that the prices of the securities of listed companies are extremely sensitive to any negative news/ publicity. Hence, even a drifting news of such a report by the auditor can send the securities prices spiraling down, exposing the investors to risk of loss at the very instant even if later on after a due investigation it is found that the so called 'fraud" was a mere *bona fide* error. It is also not clear what would be the liability of the auditor in such a situation. Another perspective to this issue, however, is the fact that while the auditor is required to make a report on frauds in terms of Section 143(12) after seeking response of the Board of Directors/Audit Committee on his observations in this regard, the shareholders would remain unaware of the fact that such report has been made to Central Government. To bring in greater accountability of the Board of Directors and Audit Committees, it may be appropriate if at least the fact of such report having been submitted by the auditor to the Board of Directors/Audit Committees and thereafter to the Central Government is made a part of the Directors Responsibility Statement or the Board's Report.

Fraud reporting is fraught with negative effects of reputation risks both for the company and its auditor, especially, where subsequently, its found to be a *bona fide* error.

Reporting on Other Information under SA 720

Reporting on "other information" contained in the documents containing audited financial statements is a requirement of SA 720. This aspect too seems to have been impacted positively by the 2013 Act. The SA 720 required the auditors to make suitable arrangements with the management to obtain such "other information" before signing the audit report. The auditors have often faced difficulties in implementation of this Standard on account of the fact that the managements were *per se* not required under the Act to provide such information before signing of the audit report. With the notification of the 2013 Act which gives a legal mandate to the auditing standards, the companies too are required to ensure compliance with auditing standards.

Finally...

The Companies Act, 2013 and the Rules have indeed made the task of the auditors of companies all the more onerous. Reporting on matters newly prescribed under Chapter X and the related Rules, particularly, reporting on IFCs and frauds, would require auditors to exercise far greater degree of professional skepticism. It will have its own implication in terms of employment of enhanced, and perhaps, different nature of audit procedures, and as a corollary, enhanced time and effort and also additional documentation requirements. It would obviously lead to increase in the time and costs of audit. It is to be seen how the Industries react to it as the cost of audit could go up significantly. Moreover, the 2013 Act provides for rigorous financial penalties as well as criminal proceedings for the auditors. The risks associated with the audit of companies seem to far outweigh the returns.

Finally, though there are quite a few issues in respect of Chapter X of the 2013 Act and the related Rules notified thereunder, this is nothing new in the lifecycle of a newly promulgated legislation of this volume. During the transition period, there are bound to be several doubts and implementation issues. But with time, as the doubts and issues get resolved through discussion and consultative processes between legislators and legislatees, and people gain more experience and comfort in implementation of the legislation in letter and spirit, the legislation would stabilise.

While the Auditing & Assurance Standards Board is in the process of taking up the issues of concern in Chapter X and related Rules with the concerned authorities, it is simultaneously working on developing guidance on the various newly inserted reporting requirements under the said Chapter and Rules so that there is uniformity in understanding of the various provisions among the members on the procedures to be applied and, finally, reporting thereon. ■