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MANDATORY AUDITOR ROTATION: CRITICAL ANALYSIS OF SECTION 139 AND 141 OF COMPANIES ACT 2013

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ABSTRACT

In the light of high-profile corporate collapses which let down the seventh largest country USA into bankruptcy in the year 2001 attributed lack of audit quality in commercial world. There was a need felt to elicit set of reforms which ought to be established to ensure proper corporate governance especially in the area of audit and auditors under commercial arena. Major corporate scams gave the world a picture of massive audit failures prevalent around the globe. A trustworthy budgetary data is the need of an hour in today's world. Especially after scandalous events of Enron and WorldCom in United States proved to the world that there's immense need of change in the mechanism to combat corporate downfall. Thus, concept of "mandatory audit rotation" came to the rescue.

A lot of countries follow mandatory rotation of auditors to ensure there is integrity, objectivity and independence given to the auditors of the company which in turn reduces the incidence of audit failure. The long-term association with the clients affects their independence as there's a sense of security developed with the clients which acts as a barrier to depict the real picture of the company with unbiased opinion and high-quality audit report. There was a need felt even in India to adopt a policy of rotating the auditors' after a fixed period to bring in more transparency in the functioning of a listed company and to avoid any impending financial irregularity in the market. In consonance with the growing need for a transparent law in this regard, the Parliament introduced a policy of Mandatory Auditors rotation under Companies Act 2013 for listed and some other specific Companies as mentioned in the Act. The same was done to encourage an autonomous and fair conclusion by independent auditors.

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The author through this paper would highlight the loophole in the present legislation and to analyze whether the provision achieve the object sought to be achieved by it through the paper would like to bring out the loophole in respect to auditor rotation in India and how it is being misused by the management and the auditor which in turn distort the overall picture of the audit environment in the country.

INTRODUCTION:

In the light of high-profile corporate collapses which let down the seventh largest country USA into bankruptcy in the year 2001 attributed lack of audit quality in commercial world. There was a need felt to elicit set of reforms which ought to be established to ensure proper corporate governance especially in the area of audit and auditors under commercial arena. Major corporate scams gave the world a picture of massive audit failures prevalent around the globe. A trustworthy budgetary data is the need of an hour in today’s world. Especially after scandalous events of Enron and WorldCom in United States proved to the world that there’s immense need of change in the mechanism to combat corporate downfall. Thus, concept of “mandatory audit rotation” came to the rescue.

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There was a need felt even in India to adopt a policy of rotating the auditors’ after a fixed period to bring in more transparency in the functioning of a listed company and to avoid any impending financial irregularity in the market. In consonance with the growing need for a transparent law in this regard, the Parliament introduced a policy of Mandatory Auditors rotation under Companies Act 2013 for listed and some other specific Companies as mentioned in the Act. The same was done to encourage an autonomous and fair conclusion by independent auditors. The provision further says that if an individual has been appointed as an auditor for a consecutive period of 5 years, he cannot again be appointed as an auditor for the next year. On the contrary, if he has been appointed as an auditor for a consecutive term of 5 years, then he would have to face a cooling off period of 5 years before getting appointed as an auditor again. A similar treatment would be meted out to a firm Post this, The Act requires a cooling of time for a period of five years a long time amid which neither the prior firm nor any of its connected firms or individuals can be designated as auditors. But the management and auditors in arrangement with each other for their shared advantage and for re-appointment of a craved individual or a firm as auditor for the second term with cooling time of one year rather than five years at the expense of different stakeholders. But the management in cohorts with a favorite individual or a firm can escape the present law by only appointing him for a consecutive term of 4 years and then re appointing him after a cooling off period of 1 year. By this the mandatory cooling off period prescribed by the legislature would be reduced from 5 years to 1 year.

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BACKGROUND:

Auditing of accounts is a compulsory and an indispensable part for incorporated entities in the corporate world. It is a tool by which the financial soundness or health of an entity could be verified. Auditing becomes more important when it is for entities who carry on businesses from capital generated from the people. Those who carry on business with other people's money have to be accountable to those people. In the financial markets, there are listed companies whose capital is generated by the shareholders, who in turn acquires a stake in those Companies. The shareholders, however, are mostly layman and ascertainment of financial health of a Company being a technical job, the auditor's act as an agency to inform the concerned people about the exact financial condition of a Company. A financial report by an auditor about a particular company helps the people to make an informed decision. There is, thus, a need for an agency like auditors in between the shareholders and management of a Company**.** These auditors should be technically qualified for the job and should also be independent, and able to withstand the pressure of management.[3] Proper and accurate compilation of financial information of a corporate and its disclosure, in a manner that is

[3] A. Ramaiya, THE GUIDE TO THE COMPANIES ACT Lexis Nexis 2575-2576 (18th edition)

standardized and understood by stakeholders, is central to the credibility of the corporate and soundness of investment decisions by the investors.[4] The auditors have a responsibility to portray a true picture of the company accounts to the general public as well as the people who have invested in the organization. Therefore, the auditor and the client share a very intricate relationship between them. Long working tenure of auditor in the same company, tends to develop a sense of security with the client. There can be some amount of influence from the clients on the auditor, dueto which the true picture of the company may not be depicted. The legislature in order to prevent a collusion between the management and an auditor and to keep a check on the auditing frauds have made amendments in the new Companies Act 2013 (hereinafter referred as the "Act") and introduced an auditor's rotation policy to plug loopholes in the erstwhile Companies Act, 1956. The main objective behind such introduction is to make the entire process more transparent and responsible towards the concerned people like shareholders etc. The amendment would also inspire confidence within the concerned populace on the credibility of the information relating to a company incorporate.

The amendment has been brought in Section 139 in Chapter X of Companies Act 2013 which has provided a mandatory rotation of auditors in the listed Companies and a class of companies to be specified by the central government. It is specifically mentioned in the provision that an auditor of listed and specified companies cannot be reappointed for the second consecutive term of five year in case of an individual and ten year in case of a firm, if the auditor has held the same office for consecutive five years as individual and ten years as a firm in the first term.

ROTATION OF AUDITORS AND ITS INDEPENDENCE:

Section 139 of the Act reads that listed companies or companies belonging to such class of companies as may be prescribed cannot appoint or reappoint an individual or an audit firm (including an LLP) as an auditor for more than one consecutive term of five years and two consecutive terms of five years each respectively**.** There is a cooling off period of five years for both individual auditors and audit firms. Audit firms having common partner or partners to the outgoing audit firm will also not be eligible for appointment till the cooling off period of the outgoing firm has expired. Companies need to be compliant with the provisions

[4] JJ Irani Committee Report on Companies Act 2013

relating to rotation within three years from the date of the commencement of the Act. Central Government may, by rules, prescribe the manner of rotation. As per the draft rules, this requirement has been extended to all companies except small companies and one-person companies.[5]

Audit quality is another vital perspective to be considered in assessing the effectiveness of adopting the policy of auditor's rotation. Since, audited financial statements are the joint product of auditor and client's negotiation process, there have been great concerns for the preservation of the auditor's independence, which lies at the heart of the integrity of the audit process. The independence of an auditor is fundamental to the reliability of auditor's report and has been adjudged as the cornerstone of the accounting profession and one of its most precious assets. Hence, its importance has been reiterated and emphasized over time by oversight boards and professional literature.[6]

LACUNA IN THE LAW:

Mandatory Auditor Rotation is expected to have a significant impact on Indian companies. All listed companies and a large number of unlisted companies that meet the prescribed criteria will have to comply with the provisions of the Act. Indian companies have three years from 1 April 2014 to implement MAR and now have less than 18 months to evaluate and recommend the appointment of a new audit firm.[7]In case where there is a violation of the provision of rotation of auditors, the same is punishable under Section 147 of the Act. However, the current provision leaves a lacuna in the shape of an event wherein order to avoid the punishments as per Section 147 of the Act, the management of the Company along with the auditors for mutual benefit may re-appoint the desired individual or firm as auditors by creating an artificial disqualification under Section 141 of the Act. In this way, the desired individual or firm as an auditor for the second term will have to go through a period of one year as a cooling off period instead of 5 years as prescribed under Section 139(2) of the Act.

This could be conceivable by getting the desired auditor excluded before the expiry of statutory time of five years, which will then outcome in an esteemed casual vacancy

[5] Companies Act 2013 New Rules of The Game October 2013
https://www.kpmg.com/IN/en/Documents/KPMG_Companies_Act_2013.pdf
[6]AICPA, 1999; POB 2000
[7]Auditor rotation A practical guide and approach Assurance November 2015 KPMG.com/in http://www.moneycontrol.com/news_html_files/news_attachment/2015/Auditor%20Rotation-A%20practical%20guide%20and%20approach.pdf

according to the considering fiction contained in Section 141 of the Act. The casual vacancy that has arisen upon disqualification may then be filled by the Board of Directors of the Company by a simple resolution as the company will not be required to pass a special resolution and obtain prior approval of the Central Government as required under section 140 of the Act[8]

The said disqualified auditor after remedying the disqualification would again become eligible for re-appointment after the appointment of another auditor during the vacancy period as his appointment is not specifically ruled out within the statutory provisions contained in Chapter X of the Act. Along these lines as opposed to experiencing a statutory chilling time of five years just a time of one year or even less would suffice for re-arrangement of a desired auditor by a Company for the common advantage of all included.

The main argument in support of such a desired appointment of an auditor would be that since he has not completed a consecutive term of 5 years as prescribed under the Act, and has held office for a period less than 5 years, there is no bar whatsoever on his reappointment after a gap of 1 year instead of a 5 year one prescribed under Section 139 of the Act A there is no legal requirement in law for them to go through the cooling off period of 5 years.

By this way the management of the company would be easily able to defeat the primary objective behind the insertion of such an amendment and it would be quite detrimental to the transparency of the financial health of the company.

ANALYSIS WITH USA LAWS:

Twelve years prior, the US capital markets were shocked by disclosures of money related scams and financial frauds in various organizations. The harm to financial investors, pensioners, diverse groups and markets was notable. Many corporate administrators were imprisoned and several indictments followed. The shock was so huge that one of the country's biggest organizations and one of the biggest review firms left their businesses. After several corporate income restatements, trust in monetary markets was shaken to the core. To reestablish open trust in the dependability of monetary detailing, the US Senate and House of Representatives passed the Sarbanes-Oxley Act of 2002, by votes of 99-0 and 423-3, separately, sending it to President George W. Shrub, who marked the change measure into

[8]Loophole in section 139 of Companies Act, 2013 (August 14th, 2016) http://taxguru.in/company-law/loophole-section-139-companies-act-2013.html#sthash.HTbTbVp8.dpuf

law on July 30, 2002. Since its institution, the Sarbanes-Oxley Act, or SOX as it is frequently called, has been both proclaimed and insulted.

The policy of mandatory rotation of audit firm is defined in the Sarbanes-Oxley (SOX) Act[9] as the imposition of a limit on the period of years during which an accounting firm may be the auditor of record. Mandatory audit firm rotation is often discussed as a potential way to improve audit quality – typically gaining attention when public confidence in the audit function has been eroded by events such as corporate scandals or audit failures[10]. SOX requires the compulsory pivot of the lead engagement accomplice at regular intervals, as opposed to seven years as had been required under earlier expert gauges. SOX also extended the five-year rotation requirement to the concurring audit partner. Concurring audit partner" (or "engagement quality reviewer" as defined in PCAOB standards) is a partner, independent of the audit team, whose role is to perform an objective review of the significant judgments made by the audit team and the related conclusions reached in forming an opinion on the financial statements. Engagement quality reviewers must provide their approval prior to issuance of an audit report.[11]

The International Ethics Standards Board for Accountants (IESBA) code of ethics 2006 defines concurring audit partner or "key audit partner" which is defined as "the individual responsible for the engagement quality control review, and other audit partners on the engagement team, such as lead partners on significant subsidiaries or divisions, who are responsible for key decisions or judgments on significant matters with respect to the audit of the financial statements on which the firm will express an opinion."[12] The term is used in the provisions on employment relationships, partner rotation and compensation. The definition of key audit partner focuses on the whether a partner is responsible for key decisions or judgments on significant matters with respect to the audit of the financial statements on which the firm will express an opinion. For instance, in the review of combined money related articulations, if the audit partner of a noteworthy auxiliary is in charge of key choices or judgments on huge matters regarding the merged monetary explanations that individual would be thought to be a key audit partner

[9]Sarbanes-Oxley Act, Section 207.
[10]McLaren 1958; Seidman 1967; Corporate Accountability Research Group 1976; Hoyle 1978; Imhoff 2003
[11]The Sarbanes-Oxley Act at 10 Enhancing the reliability of financial reporting and audit quality (August 28th, 2016)http://www.ey.com/Publication/vwLUAssets/The_Sarbanes-Oxley_Act_at_10_-_Enhancing_the_reliability_of_financial_reporting_and_audit_quality/$FILE/JJ0003.pdf
[12]The International Ethics Standards Board for Accountants (IESBA) code of ethics 2006

The key audit partner or concurring audit partner or engagement quality reviewer has a dynamic role to play in the areas of auditor rotation. Every step taken by the auditor or the audit team in the company has been reviewed by the key audit partner in the firm. In case of any audit failure or any discrepancy in the audit rotation, this partner plays a very crucial role in that aspect. He makes sure that everything in the company related to audit and auditors is going in a correct manner or not.

CONCLUSION:

With the change in the context of the changing economic and business environment and to make Indian corporate environment more transparent, simple and globally acceptable., there was a need felt to be governed under the better legislation and to repeal the old law which governed the Indian companies prior to 2013. Therefore, Companies Act 2013 was enacted. The Act promises to substantively 'raise the bar on governance' and in a comprehensive form purports to deal with relevant themes such as investor protection and fraud mitigation, inclusive agenda, auditor accountability, reporting framework, director responsibility and efficient restructuring[13]. One of the big and new provision of the Companies Act 2013 is auditor rotation. We cannot say that our Government hasn't done anything for the rotation of auditors but it does need a little change in order to fill the loophole.

As per my doctrinal research, I would like to conclude that mandatory auditor rotation has a positive impact on the audit quality of a company. It leads to the independence of the auditor so that there is no long association of the client with that of the auditor working for a company. Due to which there is no influence of clients over the auditors, which in turn leads to healthy corporate environment.

Our results show that in case of rotation or changing of auditors and there is an avoidance of cooling off period of 5 years in case of individual or 10 years in case of an audit firm in order to get back the desired auditor back to the firm without him serving a long tenure. It adversely affects the health of the company as this will again lead to biased and unfair audit reports. The Indian Legislature in the Companies Act 2013 and Companies Act Rules (Accounts and Audits) 2014 have mentioned the essence of mandatory auditor rotation and procedure of doing it. But the legislature is not oblivious of the fact that the auditors and the

[13]https://www.kpmg.com/IN/en/Documents/KPMG_Companies_Act_2013.pdf

management in collusion for their mutual benefit will avoid the cooling of period and destroy the real meaning of mandatory rotation.

This discrepancy has been solved by USA Government in the Sarbanes-Oxley Act of 2002 by appointing a key audit partner or engagement audit reviewer who is responsible to review and approve of each audit report and other related information which includes such an avoidance of cooling period. Engagement quality reviewer to evaluate risks to the firm and the company, evaluate the severity of deficiencies in control, and determine if there have been "appropriate" consultations on difficult matters.[14]

In my opinion, the concept of engagement audit reviewer can also be applied in India to keep a check on the auditor and its working.

With great power comes great responsibility. India has unprecedented power by virtue of a large corporate but along with it has come the great responsibility of protecting the interests of its investors and others of the same market. It is not easy but it isn’t impossible either.

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[14]http://www.accountingweb.com/practice/practice-excellence/auditing-standard-no-7-pcaob-strengthens-requirements-for-engagement