

INDEPENDENCE OF AUDITORS AND THEIR APPOINTMENT

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ABSTRACT

The auditors are the most important part of the company as they are the one who analysis the position of the company and are actually aware of the position of the company. The appointment of the auditor is one of the most important aspects as they play an important role. Section 139 of the Company's Act 2013 states how the auditors of the company should be appointed and the tenure of the auditors which is supplemented by the company rules. There should be independence of auditors as in case the auditors and the company collide with each other than that would create a great havoc for the investors and the shareholders who would ultimately result to occurring corporate fraud and there would be huge lose to the investors and shareholder. One such corporate fraud has been looked upon in this paper is the Satyam scam which made necessary for the laws to change and make it more strict. So in that case the Company's Law 2013 has become strict and has tried to curb the shortcomings of the company's Act 1956. Similarly there was increase in the happening of the corporate frauds in the United States so it was important for United States to come out with new laws in order to bring to an end to the corporate frauds taking place. So they came out with the Sarben Oxylen Act 2002 which made the laws more rigid for the corporate firms. Thus the paper focuses on the appointment and the importance of independence of auditors.

INTRODUCTION

This paper is regarding the auditors of the company. Who are the auditors? The auditor appointed can be an individual or the firm who analysis and verifies the operations and functioning of the company and would showcase the true financial position of the company. The auditors are an important part of the company and it is mandatory for a company to appoint auditors. The paper further showcases the need of independent auditor in the company. If the auditors are not independent then that would be a threat to the shareholders and the investors of the company. There are times when the directors and the auditors become one and which ultimately would end up in making fraudulent entries in the financial statements and creating a corporate fraud. This would heavily affect the shareholders and the investors as their money are lost and they aren't aware of the fact that where those money are gone. One of the much known examples of it is the Satyam Scam which took place in India. This scam is explained in the paper that how it took away the money from the investors and shareholders and misappropriated its financial statements with the help of the auditors. This was the biggest corporate fraud which took place in India so that is the reason government has made very strict law after the Companies Act 1956. Companies Act 2013 is a strict law which majorly curbs the ways of auditors becoming friendly with their clients and colliding with them. The rotation of the auditors has become stricter in the Companies Act 2013 so that the auditors wouldn't develop relations with their clients. The paper also states regarding the Sarben Oxylen Act 2002 which was formed for the United States of America for the strict implementation of the auditing activities to take place in United States. As before the law came into action there were many corporate companies committing fraud and because of which the money of many people were lost and there were no strict rules to implement on those fraudulent companies in order to punish for those frauds. So in order to make the laws stricter this Act was formed by the Congress party of United States. Even the Companies Act 2013, makes shows the importance of the independent auditor. The independent auditors are very much important for the company as they would be the right person to analyse the company's position. There would be a chance that the internal auditors would collide with the directors that is the reason now it is mandatory for all the companies to appoint an independent auditor for the company to ensure that the financial statements don't get misappropriated. So this paper would critically analyse that why the independence of the auditor is important.

HOW APPOINTMENT OF AUDITORS TAKES PLACE UNDER SECTION 139 OF COMPANIES ACT, 2013 AND COMPANY'S RULES

Section 139 of the Companies Act 2013 states that the term of appointed auditor or auditor firm is from the first annual general meeting till the end of the sixth annual general meeting. The ratification matter of the appointed auditor shall be mentioned in every annual general meeting. The auditor which is appointed should be satisfying the criteria which are mentioned under the Section 141 of the Companies Law Act 2013. A notice should be filed about the appointment of the auditor within 15 days of the meeting to the Registrar of the company. The companies which are listed should not re-appoint the individual auditors or firms for the term which is more than five consecutive years or ten consecutive years respectively. If the audit firms have one of those partners which have already been appointed then that audit firm cannot be appointed in the immediately preceding term in the name of the other partners. In respect of the provisions of clause (1) of Section 139 regarding the term of auditor given the retiring auditor can be re-appointed under certain conditions such as: (i) he shall not be disqualified for re-appointment (ii) Regarding re-appointment, the auditor has not given any notice for his refusal or any special resolution for not re-appointing that auditor has been passed at the meeting.

In the Government Company the auditor shall be appointed by the Auditor General and Comptroller of India for the financial year within 180 days and the term of holding the office would end at the end of the annual general meeting. Here in Government Company the appointment of the first auditors shall be done within 60 days of registration of the company by the Comptroller and Auditor general of India. In case if the Comptroller and Auditor General of India fail to appoint the auditor then the appointment shall be done by the board of directors within 30 days. In case of failure of the Board Directors then the appointment shall be done by the company members by extra-ordinary general meeting in the time period of 60 days. The term of holding the office of the auditors who are appointed would be till the end of the first annual general meeting.

Whereas when the first auditor is to be appointed by the company, not being a government company the auditor has to be appointed by Board of Directors in the period of 30 days from the day of registration of company. If the Board couldn't appoint the auditor then that shall be

done by the members of the company within 90 days by organising an extraordinary general meeting where the auditor shall be appointed and this auditor's term for holding the office is till the end of first annual general meeting.

If there is a case of the casual vacancy in the Government Company where the auditors are to be appointed by the Auditor General and Comptroller of India then that vacancy should be filled up within 30 days. In case the Auditor General and Comptroller cannot fill up the vacancy then the Board of Directors may do so in the period of next 30 days. While in other case of the auditor can be appointed by Board Directors in the period of 30 days. And if somebody has resigned then filling of that vacancy should be approved in the general meeting within 3 months and term of holding the office is till the end of next annual general meeting.

It is mandatory to form an audit committee under Section 177 of the Companies Act, for the company and all the recommendations for the appointment of the auditors shall be taken from the audit committee.

While the company rules of 2013 stated the company at any point in time should not be in a situation of not having auditors. The Board of Directors should appoint the auditors of the company with the recommendation of the Audit committee. The appointment of auditors can be individual auditor or a firm. The recommendation of the audit committee is not taken into consideration by the Board Members then proper justifications and the reasons for the same have to be mentioned. Then the audit committee can rectify its recommendation and send it again and if again the board doesn't approve by it then the reasons have to be properly mentioned and the issue should be placed in the Annual General meeting. The term of the auditors which is made in the annual general meeting extends till the end of the sixth annual general meeting. If the need of removal of the auditor is required then that can be done in any annual general meeting till the 6th annual general by passing ordinary resolution. The auditor or the audit firm which is selected by the board of director should not be associated with the retiring under the same network of audit firms.

There was this once case decided by the National Company Law Tribunal, Hyderabad where the point of issue was that auditors appointment being non-ratified which led to the removal of the auditors. The case was SPC & Associates, Chartered Accountants v. DVAK & Co and Anr

. where the company appointed the petitioners as the statutory auditors at the Annual General Meeting of the company for the period of five years. The appointment of the auditors was to be ratified at all the Annual General meeting. While in the next meeting the ratification didn't take place from the members and removed those auditors and appointed the respondent company as the statutory auditors without taking permission from the Central Government. So here it was the case that the appointment as well as the removal of the auditors was done in an improper manner. So here it was held by the National Commission Law Tribunal that the removal of the petitioners without ratifying the appointment by the members in the Annual general meeting was improper and without permission of the Central Government the appointment of respondent auditors was also improper according to Section 140(5). So keeping in mind Section 139 and Section 140 of appointment and removal of auditors the company took an improper step. Even as per Rule 6, explanation II (b) it is seen that the respondent firm isn't eligible to be appointed under this. So here it has been properly stated by the National Commission Law Tribunal that the appointment and removal of the auditors as per the statute is very important and thus one company cannot do that according to its wills and fancies.

WHY IS THERE A NEED OF INDEPENDENT AUDITOR?

Independent auditor of the firm is the one who is "Certified Public Accountant" or "Chartered Accountant" who would analyse and examine the financial statements of the company with which that person is not associated with. To remove the conflict of interest, the independent auditors are of great importance. It is important for an auditor to be independent. Independent auditor is necessary for the company. So the auditor doesn't get involved with the company and doesn't misappropriate with the financial statements of the company. So the companies act has given the provision of rotation of the auditors. The term of the auditors is for five years which means that the company law encourages the rotation of the auditors. So the main purpose of rotation of the auditors so that they don't get close to the clients and misuse the power which would largely affect the public at large . The regulators around the world has thought upon that there should be two kinds of procedures included for auditors in the company i.e. rotation of auditors and joint auditor committee. The joint audits would be important as the large companies would be exposed to the international markets. So the large companies would

recommend international audit firms which would be threat for the other audit firms. So there should be joint audits which are a mandate for the large companies. The definition of the large companies is not specified in the Act but it would roughly suggest that the company which has minimum net worth of 500crores rupees. Many a times there have been suggestions of mandating joint audits for all the listed companies so there is transparency in auditing and the shareholders of the companies are not cheated in anyway. There have been many cases in the past which showed that due to the non-independent of the auditor there has been many frauds in the world. One of the fraud is the Enron Scandal where the there were thousands of employees who lost their jobs and many lost retirement accounts, many shareholders lost their money which would account to \$74 billion and many investors lost their money. This happened due to misstatement in the financial reports. The auditor and the company became one and due to which they didn't show the real position of the company on the balance sheet. The debts of the company were not showed in the balance sheet. The company got caught when the stock prices got very high and suddenly there was a downfall. Before the downfall most of the top executives had sold their shares which got a suspicion in the mind of Sherron Watkins . While the other scandal was the WorldCom Scandal which was a telecommunication company, where the company inflated its assets and due to which the employees lost their jobs and investors lost their money worth \$180 billion because of the inflated assets worth rupees \$11 billion. The fake accounting statements made all this mess and the main involvement in this scam were the internal auditors of the company. \$3.8 billion were uncovered in the fraud. The HealthSouth Scandal was also one of the biggest corporate frauds which took place in the United States. This was the public company trading Heath care in the United States. Here in this scandal the major role was played by the Chief Executive Officer, Mr Richard Scrushy who inflated the earnings of the company upto 1.4 billion dollars in order to meet up to the expectations of the stakeholders. The way the fraud was caught was when suddenly before the company declared its loss he sold 75 million dollars stock in a day which put a great suspicion over him and then due to which he got caught. Due to the happening of these corporate frauds taking place many people lose their money in great number and the rise to these corporate frauds show the need of the independent auditors for the company. Independent auditors would protect the shareholders and investors who have invested this lump sum amount of money in the company.

By these scandals we come to know how important it is to have an independent auditor in the company, in order to keep the interest of the employees, investors, shareholders of the company intact. The much known corporate scandal which took place in India was the Satyam Scam is elaborated as how it took place and how there was an emerging need of bringing up the new company law act in order to save people from being the victims of these crimes.

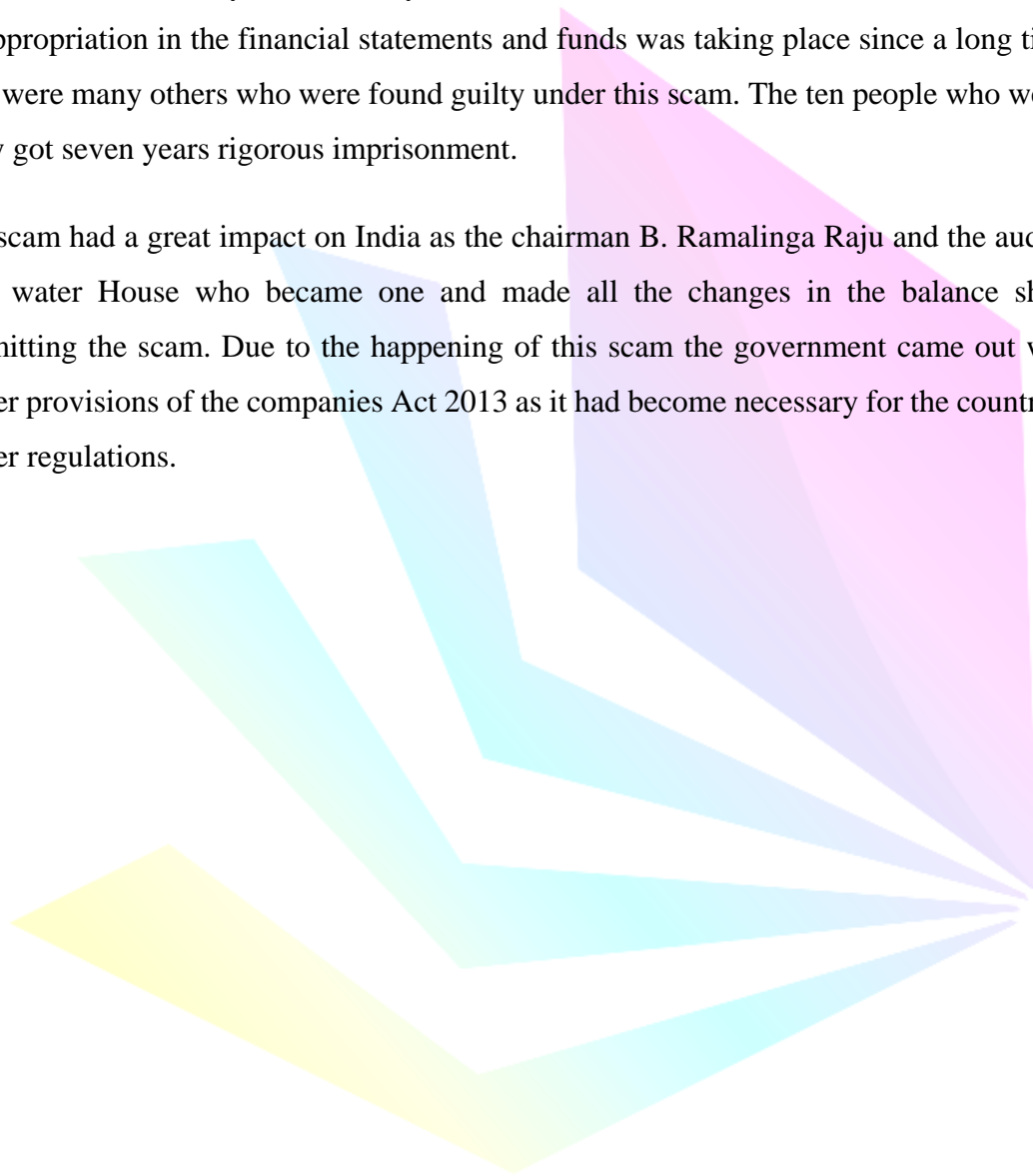
SATYAM SCAM- MAJOR ACCOUNTING SCAM

The satyam scandal was a very major scam which took place in India. This scandal took place due to the involvement of the auditors and directors of the company. The fraudulent activities which took place in the corporate sector kept the investors, stock market, investors and regulators in the dark. Here in this scam the promoters were not only too blamed as the scale on which the scam took place was huge. It wouldn't be possible without the involvement of the auditors and the directors of the company. While on investigation done by the Serious Fraud investigation office it was concluded that even the independent directors didn't have the knowledge of the misappropriation of the financial statements taking place.

The chairman of satyam corporation B. Ramalinga Raju confessed about the 7,136 crore corporate fraud committed and then resigned from the company . He stated that the profits and the financial statements are being misappropriated since many years and he alone took the sole responsibility of being involved in it. At that time when the investigation took place in this huge scandal it was observed that firstly there was great inflated revenues and profits were shown. Here the inflated means that to show the balance sheet where the liabilities are understated and the assets are overstated. Due to which the profits of the company would be seen increasing which showed the increase in market capitalisation and giving away of the bonus shares by increasing number of shares. When there was increase in the prices of the shares at that time the promoter sold their shares at high prices so the stake of the promoters reduced from 25.6% in 2001 to 8.46% in 2008. Then, the cash was raised by satyam computer services limited which were invested in Matya, a real estate family construction company which was in Andra Pradesh. As the money was invested there was very less actual cash with Satyam but the balance sheet of the accounts of satyam reflected something else. The fictitious

assets were so much. They paid taxes of huge amount to the bank accounts but the actual cash in the bank was very less all they did to set off was to show about the fictitious assests. Now to balance out the amount the chairman tried to acquire Matya in order to fill up the amount of the fictitious assets but that couldn't happen as the investor didn't agree and rejected it. So, now there was no way out for satyam and thus the chairman made confession that the misappropriation in the financial statements and funds was taking place since a long time and there were many others who were found guilty under this scam. The ten people who were held guilty got seven years rigorous imprisonment.

This scam had a great impact on India as the chairman B. Ramalinga Raju and the auditors of Price water House who became one and made all the changes in the balance sheet for committing the scam. Due to the happening of this scam the government came out with the stricter provisions of the companies Act 2013 as it had become necessary for the country to get stricter regulations.



PUBLIC ACCOUNTING REFORM ACT WAS BROUGHT BY THE AMERICA KNOWN AS- SARBEN OXYLEN ACT 2002

The auditors hold a great position and role in the company. The misuse of the auditing power would greatly affect the people who have invested in companies which has misleading financial statements. As the financial statement shows the overall stability and the efficiency of the company so the auditors shouldn't form coalition with the company and misuse the powers. The Enron Scandal was one such biggest scandal of the United States which showed the people that the strict rules for the corporate field has become a necessary .In order to keep the interest of the shareholders in mind the United Nations formed Sarben Oxylen Act 2002.

During the 1990s there were many fraudulent activities taking place which took away the investors trust away from the corporate sector. So in order to curb these misleading and fraudulent activities, Congress took out the Sarben Oxylen Act in the year 2002. There were many trading business companies who have manipulated their financial statements and published them which would not show the real position of the company and would keep the investors and the shareholders in dark. This would happen when the auditing of the financial reports is not taken place. There were many well known companies which crashed such as Enron, Xerox and Global Crossing. Later on, many other companies restated financial statements. This gave a huge impact on the stock market which gave an alarm to the Congress to form laws regarding the same so the Sarben Oxylen Act 2002 was enacted by United States of America .

Sarben Oxylen Act, 2002 had a great impact on the small public traded business and even the big public traded business, the main two sections of the act were section 302 and section 404. Section 302 states that it is mandatory to certify the reports prepared on the financial statement by the Senior Management. While the Section 404 would make it compulsory for all the public traded businesses to set up internal control and maintain financial management procedures. These procedures were supposed to be maintained, documented and tested to ensure the effectiveness of it. The impact of this law was great as it established a Public Company Accounting Oversight Board which was an independent organisation and was given the authority to regulate and see if it is implemented all the regulations related to accountings. The Securities Exchange Commission empowered Public Company Accounting Oversight

Board. So now as this Board was established all the public traded companies were mandatory to register and if the company has not registered then it would be illegal for those companies to issue the audit reports. The board has the right of questioning the auditors of the companies and even give punishment if they find any wrong happening in the accounting system of the company. The other major implication was such that the auditors of the company had report to the Audit Committee (which would mandatory include financial expert) . The shortcoming was that the auditor used to report their executives and would resolve internally but now they as they had to report to whole committee so the assessment would be done in a proper manner. So the Chief Executive officer and the Chief financial officer has to certify the financial statements and reports and they would be held responsible if anything if found misleading.

Due to this law and its implications, it was first very much criticized as it had a very lengthy procedures and it would increase the workload of the company due to stringent implications of the laws. But when the law got daily in use it was observed that it was benefited people and protected them and there was no major fallout of the public companies. Due to this law the internal controlling of the company had become effective and much more systematic and reliable even the statistics states that the investors are more confident in investing in the companies as they know that they are protected by this law . So the implication of Sarben Oxylen Act is still prevalent.

COMPARATIVE STUDY BETWEEN 1956 AND 2013

There were many defects in the 1956 Act which gave a need to make a new act. As there were corporate scandals taking place of them was the very famous Satyam scam which took place which gave a rise to form strict rules and laws for the corporate world. So here we should look upon the comparison between the Company's Act 1956 and the Company's Act 2013.

Regarding the re-appointment of auditors

According to the section 139(2) of Company's Act 2013, the re-appointment of an individual auditor for more than five consecutive years cannot be done. While the audit firm for two consecutive terms of five years can be appointed, not more than that. The audit firm who has

the common partner to the other audit firm which was already appointed as the auditor for the immediately preceding years and its tenure has been expired that firm cannot be appointed as auditors. While according to the section 224(2) of the company's act 1956 stated that any auditor who is retiring can be re-appointed as the auditor at any annual general meeting under Section 224A (1B) unless

- 1) He is disqualified for re-appointment.
- 2) He has given the notice to the company in writing regarding his unwillingness to join the company.
- 3) The company has passed a resolution of appointing somebody else instead of him to be the auditor or the resolution of not appointing him as the auditor of the company.
- 4) On the grounds of incapacity, death or disqualification, the notice has been given on an intended resolution to appoint some person in place of the retiring auditor.

In context of term of Five Years

In accordance to the company's Law 2013 Section 139(1) talks about that the auditor or the audit firm including LLP should be appointed for term of five years that is till the 6th Annual General meeting. Meanwhile the ratification in appointment for 5 years would be subject to every Annual General Meeting.

While in the Section 224(1) of the Company's Law Act of 1956 states that the appointed auditors can hold its position up to the next Annual General Meeting only and the chances of re-appointed from then on.

In regards to re-appointing existing auditors automatically when not re-appointed or appointed at the Annual General meeting

According to the company's Law 2013 Section 139(10) in this case the auditors who are existing should be persistent to be auditors.

According to the Section 224(3) of the Company's Law Act of 1956, this stated that if there is no appointment of auditor or re-appointment of auditor at the Annual General Meeting, then the position would be filled up by the Central Government.

Temporary filling of vacancy of Auditors

According to the company's Law 2013 Section 139(8) (i) states that in the period of 30 days the board should fill up the time bound vacancy. The company should fill up the vacancy within the period of 3 months if there is resignation of the auditor. If this is the reason then the term of three months would be counted from the day the board has given recommendation and that auditor would be appointed till next Annual General Meeting only.

According to the Section 224(6) of the Company's Law Act of 1956, the board should fill the temporary vacancy. The members who are present in the meeting should appoint if the casual vacancy is due to resignation of the auditor. The auditor appointed by such reason is only appointed till the end of the next Annual General Meeting.

Recommendations for appointing auditors by Audit committee

According to the company's Law 2013 Section 139(11), when there is formation of the Audit committee in the company then the recommendations of the audit committee shall be considered in appointing statutory auditors which would even consist of casual vacancy.

In the Company's Law 1956 there was no such provision regarding the same.

CONCLUSION

The auditors play a very important in the functioning of the company. The auditors are the one who have the skills to manipulate the balance sheet and even to rectify it for the betterment of the shareholders and the investors. The power of the auditors should be used wisely. By the paper we have observed that how the 1956 companies act was so different from the Companies Act 2013. Due to the Satyam scam which took place created havoc in the country as many people lost their money that had faith in the company and invested the money in the company

so the government found a need to form new better strict provisions for the companies so that they cannot lure the investors and the shareholders. The actual position of the company should be clearly shown by the auditors and the need to gain the trust of the people had become very much important for the government so this new act came into force, which made the laws for the companies strict and gained the trust of the people. Even to ensure the independence of the auditors is very important and has become mandatory to appoint an independent auditor. So stated in the paper the independent auditors play an important role in the company and though it has become mandatory to appoint independent auditors still there are certain pros and cons of having them. Even in United States of America there had been many cases of corporate frauds due to which the Congress party of that country also formed a new act named Sarben Oxylen Act 2002, which even made laws strict for United States. Firstly this law was very much criticized as that had made burdensome for the companies but then the implications of it had become so beneficial for the people and the company that that act has been still in implementation till today. So in this era, due to many corporate frauds taking place the government has tried to curb that fraud and made safe for the people for investing in the companies. Even the auditors who are being appointed their rights are also being secured by the Companies act, as the company cannot remove or appoint any auditor according to its need and requirements. As we look into the case given above which clearly holds company liable by not abiding by the rules of appointment of removal of the auditor which shows that the auditors are also secured under this Act. Thus, the role of auditors is important as without the analysing the functioning of the company and without preparing the financial statements for the company the company holds no point. So the auditor's appointment and independence also holds a great impact on the company so it should be done in a proper and fair manner.

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