CORPORATE GOVERNANCE AND CORPORATE FAILURE: AN INVESTIGATION INTO INDEPENDENCE AND EFFICACY OF AUDITORS IN INDIA

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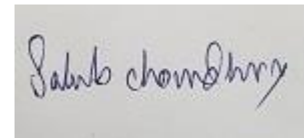
This is to certify that Rashi Gupta is pursuing Masters of Law (LLM.) from National Law University and Judicial Academy, Assam and has completed her dissertation titled **"CORPORATE GOVERNANCE AND CORPORATE FAILURE: AN INVESTIGATION INTO INDEPENDENCE AND EFFICACY OF AUDITORS IN INDIA."** The research work is found to be original and suitable for submission.

Date: August 17, 2020



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DECLARATION

I, **RASHI GUPTA**, pursuing Masters of Law (LLM) from National Law University and Judicial Academy, Assam do hereby declare that the dissertation **"CORPORATE GOVERNANCE AND CORPORATE FAILURE: AN INVESTIGATION INTO INDEPENDENCE AND EFFICACY OF AUDITORS IN INDIA"** submitted by me for is an original research work and has not been submitted, either in part or full anywhere else for any purpose, academic or otherwise, to the best of my knowledge.

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PREFACE

Corporate Governance involves the building of a set of relationships between the company, its board, the management, the shareholders and other stockholders by putting in place a structure and a system through which the established goals of the company may be achieved. The Corporate boards, as the apex governing organizations, are responsible for practicing good governance. The recurrent corporate failures have been reported around the world and in India like Enron, WorldCom, Satyam, and PNB etc. This corporate misconduct is a symptom that corporate governance mechanism has failed to come up to the expectations of various corporate constituencies. There is perceptible lack of public confidence in the develop governance structures and tools that are capable of thwarting attempts to undermine norms of good governance.

Auditors and audit committee are the watchdogs of corporate governance and act as a tool to bolster public and investor confidence in corporations. Huge corporate companies have had a crash landing after having flight owing to corporate governance failure. Role of auditors in corporate governance mosaic has come under canner owing to huge financial scams taking place like Enron in The USA and Satyam in India. Plethora of legal amendments has been done to enhance the independence of auditor to increase their efficacy to provide true and fair account of financial statement of a company. Recently PNB and IL&FS scam jolted India with the humongous amount of frauds committed that has brought more to mud name of auditors for not being able to detect frauds of such huge amounts and also raised questions on auditor and audit committee independence and efficacy.

This paper will discuss about the concept of development of concept of corporate governance in India and compares the practices of corporate governance followed in India and also discusses the role of auditors in various corporate governance failure cases. This paper also analyses the legal principles that regulate the auditors in India and enhance their efficacy and independence.

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2018 - Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations

LIST OF ABBREVIATION

1	AGM	Annual General Meeting
2.	CA	Charted Accountant
3.	CARO	Company Auditor 's Report Order
4.	CEO	Chief Executive Officer
5.	CFO	Chief Financial officer
6.	CII	Confederation of Indian Industries
7.	CLC	Company law Committee
8.	CS	Company Secretary
9.	HDFC	The Housing Development Finance Corporation Limited
10.	IICA	Indian Institute of Charted Accountant
12.	IL&FS	Infrastructure Leasing & Financial Services Limited
13.	INR	Indian Rupee
14.	IT	Information Technology
15.	LLP	Limited Liability Partnership
16.	LODR	Listing Obligations And Disclosure Requirements
17.	LOU	Letter Of Undertaking

18.	MCA	Ministry of Corporate Affairs
19.	MNC	Multi National Company
20.	NCLT	National Company Law Tribunal
21.	NFRA	National Financial Regulatory Authority
22.	PNB	Punjab National Bank
23.	PSU	Public Sector Undertaking
24.	PwC	Price water Coopers
25.	RBI	Reserve Bank of India
26.	SEBI	Securities and Exchange Board of India
27.	SIDBI	Small Industries Development Bank of India
28.	SIFO	Serious Fraud Investigation Office
29.	SOX	Sarbanes-Oxley Act
30.	UK	United Kingdom
31.	USA	United States of America
32.	USD	US Dollar
33.	UTI	Union Trust of India

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CHAPTER 1

INTRODUCTION

"Corporate governance is concerned with holding the balance between economic and social goals and between individual and communal goals. The governance framework is there to encourage the efficient use of resources and equally to require accountability for the stewardship of those resources. The aim is to align as nearly as possible the interests of individuals, corporations and society."

Sir Adrian Cadbury[1]

The Above words said by Sir Adrian Cadbury clearly signify that corporate governance is very necessary for everyone to prosper an individual, corporations and society. Individual in the above definition refers to minority shareholders and protection of their interest in the company in the company. The word corporation here means the company as a whole organization should benefit and prosper in the long term because of proper structural and managerial functioning of the organization. The communal goal i.e. to benefit the community should be achieved by individuals and corporations together. There is need to strike a balance between social and economic and individual and communal goal. There has to be accountability so that the resources are used efficiently in the best possible way for the best results. It can be inferred from the words above that any disturbance in this balance and accountability can lead to loss and exploitation of one or other. The concept of corporate governance is very necessary for proper administration, stable growth and long term gains.

[1]Sir Adrian Cadbury, *Corporate Governance Defined: Not So Easily*, CORPGOV, (April 18, 2020, 6:00 PM), https://www.corpgov.net/library/corporate-governance-defined

What Is Corporate Governance

This definition was given by OECD in 1999 corporate governance is an arrangement for business organizations to be managed. The corporate governance norms aid to evenly distribute the rights and duties among different people associated with the Corporation like the board of director's, manager's, shareholders and other stakeholders. These norms also specify the rules and procedures governing the decision making in an organization. The result of this arrangement is that goals are clear and the ways to attain these goals are implemented accordingly by the organization.[2]

Corporate governance refers to the set of systems, principles and processes by which a company is governed. They provide the guidelines as to how the company can be directed or controlled such that it can fulfill its goals and objectives in a manner that adds to the value of the company and is also beneficial for all stakeholders in the long term. Stakeholders in this case would include everyone ranging from the board of directors, management, shareholders to customers, employees and society. The management of the company hence assumes the role of a trustee for all the others[3]. Corporate governance essentially involves balancing the interests of the stakeholders of a company, management, customers, suppliers, financiers, government and the community. Corporate governance encompasses practically every sphere of management, from action plans and internal controls to performance measurement and corporate disclosure. It thus provides a framework for attaining company's objectives, promoting corporate fairness, transparency and accountability.

Governance refers specifically to the set of rules, controls, policies, and resolutions put in place to dictate corporate behavior. Proxy advisors and shareholders are important stakeholders who indirectly affect governance, but these are not examples of governance itself. The board of directors is pivotal in governance, and it can have major ramifications for equity valuation. A company's corporate governance is important to investors since it shows a company's direction and business integrity. Good corporate governance helps

[2] *OECD Definition of corporate governance*, OECD, (April 20, 2020, 8:00 AM), http://www.oecd.org/corporate/

[3] Lisa Mary Thompson, *What is corporate Governance*, ET, Jan 18, 2009, 12:19 AM, (April 20, 2020, 9:00 AM) https://economictimes.indiatimes.com/money-you.

companies build trust with investors and the community. As a result, corporate governance helps promote financial viability by creating a long-term investment opportunity for market participants. Communicating a firm's corporate governance is a key component of community and investor relations as it helps the investors know financial viability of a company and their financial interest in the company is protected, in other words the investors will know whether to invest in the company can be fruitful for them or not. On Apple Inc.'s investor relations site, for example, the firm outlines its corporate leadership its executive team, its board of directors—and its corporate governance, including its committee charters and governance documents, such as bylaws, stock ownership guidelines and articles of incorporation. Most companies strive to have a high level of corporate governance. For many shareholders, it is not enough for a company to merely be profitable; it also needs to demonstrate good corporate citizenship through environmental awareness, ethical behavior, and sound corporate governance practices. Good corporate governance creates a transparent set of rules and controls in which shareholders are aware about the company's financial position, possible future strategies for betterment, long term objectives of the company etc.

The issue of corporate governance gained prominence with the publication of Jensen and Meckling's article (1976) which triggered a body of theoretical and empirical work on the subject. During the 1970s and 1980s, theoretical and applied research work on Corporate Governance was focused primarily on US corporations. By the early 1990s similar work had been done in other developed countries such as Japan, Germany, and the United Kingdom. This was quickly followed by research on corporate governance in emerging markets.[4]The debate on corporate governance in India thus draws heavily on Anglo-American experience, literature and practice. Indian corporate sector regulators have been quick to assimilate and apply international corporate governance practices. But these practices do not necessarily signal convergence in the values embedded in our national culture. Given the manner in which Indian firms have evolved since independence, and the role that financial institutions have played, corporate governance issues and problems in India are different to those typically encountered abroad. Adopting international CG

[4] Lalita S. Som, *Corporate Governance Codes in India*, 41, EPW, 4153, 4153–60, (2006), (April 21, 2020, 5:00 PM) www.jstor.org/stable/4418757.

practices without suitable modification does not, therefore, help to address or resolve specific governance issues plaguing the behavior of Indian firms. Issues such as the effect of ownership concentration on shareholder rights, the role of relationship-based activity between banks and non-bank corporations, its impact on creditor participation in corporate governance, the prevalence of insiders and promoters, the effect of social and corporate culture on disclosure, transparency and enforcement, etc, cannot be resolved simply by transplanting international Corporate Governance practices.

Issues of Corporate Governance arise because of the separation of ownership from management and control in modern corporations. In economic parlance, Corporate Governance issues arise wherever contracts are incomplete and agency problems exist. Given this separation of ownership from control and the involvement of stakeholders, CG concerns the way in which other shareholders and stakeholders can legitimately exercise influence and exert effective control over the actions of corporate managers/promoters. The discipline of corporate governance has developed as a way of ensuring that: (a) investors other than promoters receive a fair return on their investment by protecting them against management expropriation or use of the investment capital to finance poor projects[5] and (b) other stakeholders are assured that their interests are properly catered for. Corporate Governance is a system by which firms are directed and monitored[6].

History of Corporate Governance in India

The adoption of international Corporate Governance practices has made little difference in India; Corporate Governance still has the potential to play a very important role in India's long-run and sustainable economic growth. India effectively began its move towards a more open and market friendly economy in 1991. Since liberalization, India has seen a spectacular growth in the size of its stock markets, i e, number of firms listed and the value of the shares listed or the market capitalization. The importance of corporate governance is reflected in the growth that Indian stock markets have made in

[5] Shleifer and Vishny, *A Survey of corporate governance*, 52, JOF, 737, 737-783, (June 1997), (April 22, 2020, 11:00 AM) https://www.nber.org/papers/w5554.

[6] Joseph P.H.Fan and T. J. Wong, *Do External Auditors Perform a Corporate Governance Role in Emerging Markets? Evidence from East Asia*, Journal of Accounting Research, 43(1), 35, 35–72, (2005), (April 22, 2020, 11:45 AM), www.jstor.org/stable/3542415.

the last decade. During the capital market boom of 1993-95, many companies that tapped the capital market for funds de- faulted in their commitments and simply vanished. Hundreds of obscure companies made public issues at large premium, with the help of obscure investment banks and misleading prospectus.

The theme of corporate governance has attained prominence particularly since the 1980s and all the more so after the code of corporate administration issued by the Cadbury advisory group. The well-known Cadbury Committee characterized "corporate governance" in its report (Financial Aspects of Corporate Governance, distributed in 1992) as "the framework by which organizations are coordinated and controlled".

In accordance with the Cadbury Council, the Kumar Mangalam Birla Committee additionally issued a code of corporate administration for organizations in India. As part of the corporate culture prevalent worldwide, directors are in charge of the administration of their organizations. The investors' job in administration is to choose the director and the administrators and to fulfill themselves that a fitting administration structure is set up[7].

Corporate governance initiatives in India began in 1998 with the Desirable Code of Corporate Governance – a voluntary code published by the CII. Later in May, 1999, SEBI had set up a committee with Shri Kumar Mangalam Birla as its chairperson, then Member of the SEBI Board to bolster the standards of corporate governance. Based on recommendations given by this Committee, a new clause 49 was incorporated in the Stock Exchange Listing Agreements in February. The term Clause 49' refers to clause number 49 of the Listing Agreement between a company and the stock exchanges on which it is listed (the Listing Agreement is identical for all Indian stock exchanges, including the NSE and BSE). This was the first formal regulatory framework for listed companies specifically for corporate governance. Under this clause, SEBI has prescribed a format in which the information shall be obtained by the Stock Exchanges from the companies. Corporate governance covers a wide range of arrangements. Scholars classify these arrangements into internal and external mechanism. With internal mechanisms; the ownership structure of the firm, the board of directors, the auditor and the audit

[7] Anubhav Pandey, Regulatory Framework for Corporate Governance in India, IPLEADERS, 20-5-2017 (April 24, 2020, 10 AM) https://blog.ipleaders.in/corporate-governance.

committee, other committees of the board like nomination committee, remuneration committee acquire special significance. Within external mechanisms; the market for corporate control and product market competition play a significant role in improving corporate governance[8].

The internal and external mechanisms in turn are shaped by the overall legal and institutional structures of the country Broadly the companies have to submit compliance status on eight sub clauses namely: Board of Directors; Audit Committee; Shareholders Investors Grievance Committee; Remuneration of directors; Board procedures; Management Shareholders and ownership structure; and Corporate Governance report. The intention of Birla committee behind recommending insertion of Clause 49 initially was to introduce some basic corporate governance practices in Indian companies and because of introduction of this clause a number of key changes in governance and disclosures which had to be followed by companies. The changes brought about by the introduction of this clause, many of which are take for granted today like the reports prepared and submitted to the committee are solely in the hands of management and are just done on paper to show with no practical significance and reality to it. The clause specified the requirement of independent directors to be members of the board; and at least one-third board shall consist of them. The setting up of an Audit committee, and a Shareholders 'Grievance committee, among others, were made mandatory as were the Management's Discussion and Analysis (MD&A) section and the Corporate Governance Report in the annually disclosed Report, and disclosures of fees paid to non-executive directors. A limit was placed on the number of committees that a director could serve on.

This Clause 49 went through a number of amendments before gaining the present status. Clause 49 of the SEBI guidelines on Corporate Governance was amended on 29 October 2004. The amendment made major changes in the definition of independent directors, empowering the audit committees with new duties, ensuring better financial control by enhancing the quality of financial disclosures, including those relating to related party transactions and proceeds from public/ rights/preferential issues, requiring Boards to adopt formal code of conduct, requiring CEO/CFO certification of financial statements

[8] Bhumesh Verma and Himani Singh, *Evolution of Corporate Governance in India*, 69,PL (CL) November, 2019, (April 25, 2020, 12:00, PM) https://www.scconline.com/blog/post/2019/11/13/evolution-of-corporate-governance-in-india.

and for improving disclosures to shareholders. Certain non-mandatory clauses like whistle blower policy and restriction of the term of independent directors were also introduced[9].

Role of Auditors in Corporate Governance in India

Auditor can be defined as a person or firm hired by a company to audit its account and present a financial report. The need for good Corporate Governance essentially arises due to the division between ownership and control which characterizes almost all modern companies. The primary trouble with such division, which forms the principal focus of corporate governance principles, is what is known as agency costs i.e. the tendency of the management, through its various instrumentalities, to sub serve the stake holder's benefits to other objects which affect these stakeholders detrimentally. Auditors are one such agency which allows the shareholders of a company to get an unbiased analysis of the finances of the company yet smooth day to day functioning of the auditors depend a lot on the cooperation by the management with whom the auditors interact more, as result many a times the management finds that auditors could be more pliable then the shareholders and commit fraud with the collusion of the very agency which was supposed to check and prevent such practices[10].

The emergence of corporate governance in India following the trends of corporate governance practices of USA and UK, practically India was far behind and witnesses many frauds owing to corruption in the corporate world leading to corporate governance failure. Satyam scam was the final nail in the coffin; the humungous scam jolted the nation and questioned the corporate governance practices and shedding light on the corporate governance failure. The legislature and the executive became very active in battling the corporate governance failure. Law was amended and the role of auditors came into play.

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[9] SEBI, *Recommendations of the Narayan Murthy Committee on the Revised Cl. 49–Corporate Governance*–Press Release, SEBI, last updated on 15-12-2003 (April 26, 2020, 12:18 PM) <https://www.sebi.gov.in/media/press-releases/dec-2003/recommendations-of-the-narayana-murthy-committee-on-the-revised-clause-49-corporate-governance-press-release_17040.html.

[10] Navajyoti Samanta and Tirthankar *Das, Role of auditors in Corporate Governance*, SSRN, (April, 28, 2020 , 11:00PM) https://poseidon01.ssrn.com/delivery.php.

In the Indian context, the Irani Committee had suggested a four point agenda to be adhered to in the company's preparation of its account which is as follows: Disclosure accuracy and adequacy Standardization, Clarity Synchronization of law and Accounting Standards Auditors of the Company play an important role in all the aforementioned aspects of Governance. The provisions from Section 224 to 233 of the Companies Act which seek to regulate the audit of company's accounts and its external auditors are the incorporation of the four point agenda as suggested by the Irani Committee. The auditors act as eyes and ears of the shareholders and prospective investors, thus to instill confidence in market and to provide a genuine account of the company the role of an unbiased objective auditor is an undeniable necessity[11].

There had been a flurry of recommendations and enacted self regulations, the pace of which increased after the Indian IT giant Satyam entered the hall of infamy with the biggest auditing fraud in Indian corporate history. The primary duties of statutory auditors have been listed in Section 227 of the Act. The common factor between the powers given to the auditors and the consequent duties imposed on them is that the audit of the company should be carried on in such a way that the auditor is in a position to certify that so far as the financial statements and revenue statements of the company is concerned, it gives legitimate view[12] of the company's financial position[13]. In reaching this opinion, the duties of the auditor broadly involve conducting enquiries[14] , reporting on the basis of such enquiries to the members on the compliance of the propriety and adequacy of accounting standards adopted in the books of account, profit and loss statement and balance sheet[15]. The concept of Audit Committees was introduced in India in the year 2000 by amending the legislation related to companies[16]. Audit Committee is a committee of directors (mainly nonexecutive) whose primary responsibility is to review books and accounts of the company financial statement before giving their rein to the management. Section 292A requires that both the internal auditor and the statutory auditor attend every meeting of audit committee but just to give recommendation and

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[11] Ibid.
[12] Section 209 (3), The Companies Act, 1956.
[13] A. Ramaiya, GUIDE TO THE COMPANIES ACT, pg 2373 Wadhwa & Co, (16th Edn, 2004).
[14]Section 227 (1A), Companies Act, 1956.
[15] Section 211 (c), Companies Act, 1956.
[16] Section 292A, Companies Act, 1956.

express their opinion because auditors cannot vote. Primary function of the internal auditors in the audit committee is to appraise the Committee which mainly consists of the non-executive directors of the company, with a review of the organization's power and control structures, an objective evaluation of the existing risk and the internal control framework, a systematic analysis of business processes, reviews of the existence and value of assets, reviews of operational and financial performance etc. It has however been argued that since the terms of reference of the Audit Committees are to be articulated by the Board of Directors themselves, these Committees will be effective only in a situation of voluntary compliance[17].

Therefore it can be said that mere existence of a legal framework aiding corporate governance measures will not suffice and the adherence to these rules in spirit must come from within the company itself. The auditor independence is necessary it can be seen that the law accords tremendous significance to the duty of the auditor in providing to the shareholders and accurate and fair understanding of the affairs of the company. Therefore auditors' involvement helps in safeguarding interest of the minority shareholders and to keep the financial records of the company transparent which is one of the important principles of corporate governance.

1.1. STATEMENT OF THE PROBLEM

The problem of this research revolves around corporate governance practices in India and the failure of corporate governance practices leading to big corporate frauds like the infamous Satyam scam, PNB scam. The role of auditors in the corporate governance practices has increased along with the added responsibilities by frequent amendments in the legislations. Auditor efficacy, effectiveness and independence have to be insured and enhanced. The actual incorporation of these practices will raise the corporate governance standard in India.

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[17] Pawan Agarwal, *Audit Committees – Success will depend on voluntary compliance*, 42, SCL 108, (2003), (May 25, 2020, 11:00 PM) https://www.scconline.com.

1.2. AIMS AND OBJECTIVES

The main aim of this research is to analyze the independence and efficacy of auditors in Corporate Governance practices in India and the legal framework supporting the auditors to improve and enhance the independence. Effective auditor independence will lead to a more efficient auditor.

The objectives of this research are as follows:

- To understand the concept of corporate governance and trace its emergence in India.
- Challenges faced in corporate governance in India.
- To comparatively analyze the corporate governance practices in India with the developed nations like USA and UK.
- To examine factors leading to corporate governance failures in India.
- To understand what role auditors play in corporate governance in India.
- To analyze the efficacy and effectiveness of auditors.
- To analyze whether auditors enjoy enough independence or not.
- To suggest some measures to achieve good governance and independence of auditors.

1.3. SCOPES AND LIMITATIONS

The research will focus on national as well as international practices of corporate governance. By studying and interpreting national and international committee reports on corporate governance, extracting and analyzing information secondary sources like national and internal journals, books, legislations and judgments and will try to include the analysis of such data into the study To understand the application of corporate governance norms in India, studying Indian legal framework on corporate governance and study various cases and example of corporate governance failure in India and analyze them. The limitations of the research are: The sources referred will be majorly secondary like literature from books, Journals, Articles, newspapers and will review such literature trying to find gaps in the study and analyze them. This research will be

primarily focusing on the Indian scenario of corporate governance and on the role of the auditors in corporate governance.

1.4. RESEARCH QUESTIONS

The researcher will try to find answers to following research as identified below:

- What are recent trends of corporate governance in India?
- How are the practices of corporate governance followed in India different from the practices followed in developed countries?
- What led to the corporate failure and where did the auditors lack owing to such failures in India?
- What is the role of auditor in corporate governance practice in India?
- Are the auditors efficient in incorporating Corporate Governance practices?
- Are auditors independent enough to incorporate corporate governance in?
- What is the legal framework and reforms that led to change in role of auditors in corporate governance?
- What are the loopholes in law leading to ineffectiveness of auditors?

1.5. HYPOTHESIS

The following hypotheses have been framed: -

1) Corporate Governance is a powerful tool for building trust and long-term relationship with stakeholders and any discrepancies in such practices can lead to corporate failures.
2) The effective role of auditors to incorporate and achieve these long term goal for a sustainable growth is challenged by the practices followed.

1.6. RESEARCH METHODOLOGY

This research work is based on Doctrinal Methodology. The data is collected from secondary sources like literature; the collected data is properly analyzed to conduct this

research work and find any gaps in the study. The cases on corporate failures are studied thoroughly to assess the reasons for the failure. Reports from various committees have been studied to understand the concept of corporate governance. The researcher has gone through different books, journals, articles, newspapers. This paper also includes material from national and international journals, legislations, reports.

1.7. LITERATURE REVIEW

Corporate governance codes in India by Lalita Som[18]

This article discusses the meaning of corporate governance and its practical emergence in India. The article also elaborates the debate on corporate governance in India derives significantly from Anglo-American experience, practice and literature. Indian Corporate Governance codes are based on the US and UK experiences do not resolve specific governance issues plaguing Indian firms. In spite of best efforts to assimilate and apply international Corporate Governance practices, the values embedded in our national culture have resulted in their desultory implementation. The article highlights those areas where Indian Corporate Governance practices have diverged from international best practices and how these areas are proving to be challenges in promoting good governance culture in India. One of the problems that this article points out is lack of auditor independence which creates problems for minority shareholders as there is lack of transparency in the financial statements because of autonomy of board of directors over the auditors. This article has lead the researcher to understand that practical application of US and UK model of corporate governance practice are faced with a lot of challenges because if Indian corporate structure and lack of auditor Independence being one of such hindrance.

[18] Supra note 4.

The ethical principles determining the contents of corporate governance rules and systems Michel Dion[19]:

The article analyses ethical principle of good governance as recognized by various national and international reports. The values such as fairness, accountability, transparency were recognized by the reports. Such values are required to achieve the desired confidence of shareholders and other stake- holders. This article has helped the researcher to understand these ethical values of corporate governance especially with respect to role of auditors and audit committee in achieving good governance. The Dey Report 1994 focused on the integrity of corporate internal controls. The board must ensure that the corporation has an audit system guaranteeing the integrity of data and the compliance of financial information with appropriate accounting principles. Audit committees must ensure the transparency and integrity of financial reporting (Blue Ribbon Report 1999). As the OECD Principles 2004 said, audit committees play a vital role in ensuring the integrity of business corporations. External auditors have the responsibility to audit and attest to the fair presentation of the company's financial statements, and to evaluate the company's system of internal controls. The article has shed light on the role of auditor in achieving the ethical values of corporate governance.

Corporate Governance Reforms: Redefined Expectations of Audit Committee Responsibilities and Effectiveness by Sandra C. Vera-Munoz[20]:

This article deals with reforms in corporate governance structure in USA especially after the blue ribbon committee reports in 1994, Sarbanes Oxley Act and whistle blower provisions. These reforms have intensified scrutiny of audit committees, whose role as protectors of investors' interests now attracts substantially higher visibility and expectations. As a result, audit committees face the formidable challenge of effectively overseeing the company's financial reporting process in a dramatically changed and highly charged in corporate governance environment. This study examines the redefined

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[19] Dion & Michel, "*The Ethical Principles Determining the Contents Of Corporate Governance Rules And Systems*, 27(2), Society And Economy, 195, 195–211, (2005), (April 28, 2020, 2:00 PM) www.Jstor.Org/Stable.

[20] Vera-Muñoz, Sandra C. Corporate Governance Reforms: *Redefined Expectations of Audit Committee Responsibilities and Effectiveness,* 62(2), J. Bus. Ethics, 115, 115–127, (2005), (April 29, 2020, 2:15 PM) www.jstor.org/stable/25123650.

expectations of corporate audit committee responsibilities and effectiveness in the wake of corporate governance reforms, some of the critical factors identified by prior research that contribute to audit committee effectiveness, and provides some directions for future research.

Reassessing Auditor's Role in the Indian Corporate Governance by Naveen Kumar[21]:

This article associates the changing role of auditors, initially it was to ensure transparency in the financial records of a company so as to protect shareholder rights corporate governance, but the responsibility does not end there the auditors were also supposed to be in contact with the management of the company. This role of auditors has seen a drastic change because of increase in number of auditing frauds and failures and developments in the corporate governance trends, owing to such changes the responsibilities faced by auditors have changed and their role in corporate governance has gained much more prominence. The article tries to reassess the role of auditors in the Indian corporate governance framework after the infamous Satyam scam. Therefore, the article makes an endeavour to understand the auditors' governance role in conjunction with its statutory responsibilities in this contemporary business environment. Auditors' place in the Indian corporate regulatory framework is also discussed, clarifying their conflicting position. The paper further discusses the status of auditing in India and reforms proposed in the country to strengthen the role of auditors in corporate governance.

Do External Auditors Perform a Corporate Governance Role in Emerging Markets? Evidence from East Asia by JOSEPH P. H. FAN AND T. J. WONG[22]:

This Journal article is an empirical research study on the emerging markets of eight East Asian companies. The paper discusses about the conflicts in the corporate world that take place between the controlling owner of a company and the minority shareholders. These types of conflicts are tough to tackle with conventional corporate control mechanism such

[21]Naveen Kumar, *Reassessing Auditor's Role in the Indian Corporate Governance*, RESEARCHGATE (May 2, 2020, 8:00 AM) https://www.researchgate.net/publication.

[22] Supra note 6.

as by the board of director's intervention or takeover. The journal article tries to analyze and examine the role of external auditors in a company. the journal article studies two scenarios for which external auditors are hired, one reason for employment being the auditors acting as monitors and other being them acting as bonding mechanism and in some situations it can be both. So to be clearer an empirical study is conducted where a broad sample from eight East Asian economies, the journal article documents that firms with agency problems embedded in the ownership structures are more likely to employ Big 5 auditors. This relation is evident among firms that raise equity capital frequently. Consistently, firms hiring Big 5 auditors receive smaller share price discounts associated with the agency conflicts. Also, there are findings that Big 5 auditors take into consideration their clients' agency problems when making audit fee and audit report decisions. Taken together, these results suggest that Big 5 auditors do have a corporate governance role in emerging markets.

How Satyam Scam raised the bar of corporate governance by K V Kurmanath[23]:

This newspaper article discusses the after effects of the satyam fiasco and the pointed out the flaws in corporate governance in India such as unethical conduct, fraudulent accounting, dubious role of auditors, ineffective board, and failure of independent directors and non-disclosure of pledged shares. To tackle with this problem the executive and legislators came forward with a scenario. The executive i.e. the Minister of Corporate Affairs introduced a warning system that can pick up signals from companies that are deviating from the rules and the legislature brought in changes in the Companies Act in 2013, introducing a slew of measures to ensure transparency and accountability in corporate affairs. The Independent directors were made mandatory on the board and the minority share holder were given right to file a class action suit against the company in order to protect their rights and interests. The independence of auditor was ensured as The SEBI made it mandatory to rotate individual auditors after five years and audit firms after 10 years to improve the quality of financial reporting, detect any oversight and ensure independence of auditors in the true sense. The SEBI also directed the monitoring

[23] K V Kurmanath, *How Satyam Scam raised the bar of corporate governance*, The Hindu, April 8, 2009, (May 5, 2020, 11:00 PM) https://www.thehindubusinessline.com/.

cell established by stock exchanges to ascertain the adequacy and accuracy of disclosures made in the quarterly compliance reports received from company's acts as a counter check. Companies were asked to compulsorily devise a whistle blower policy and affirming that no personnel has been denied access to the audit committee helps free communication of concerns about illegal/unethical practices.

1.8.CHAPTERISATION

- Chapter 1 deals with introduction of the topic and also discusses the definition of corporate governance and its history in India. In a brief summary this chapter introduces the role of auditors in corporate governance which will be dealt in greater details in the following. This chapters and also includes aims and objectives, scope and limitations, research questions and hypothesis of the research.
- Chapter 2 is the comparative study of the practices of corporate governance in India with the practices that take place in developed countries like USA and UK.
- Chapter 3 deals with the study of corporate governance failures and its association with the auditors.
- Chapter 4 describes in detail the development of role of auditor in corporate governance in past and present.
- Chapter 5 deals with the analyses of the changes, loopholes and reforms in recent times in the legal framework, especially with respect to the role of auditors and corporate governance.
- Chapter 6 deals with analysing the efficacy of auditors in the corporate governance practices and challenges faced by the auditors in playing a prominent role.
- Chapter 7 Conclusions and suggestions

CHAPTER 2

DEVELOPMENT OF CORPORATE GOVERNANCE PRACTICES IN INDIA

2.1. Emergence of Corporate Governance in India

Corporate governance acts as a steering agent for the survival and growth of a company. The policies of corporate governance steer the corporation towards growth in the same way as a captain sailing the ship towards its destination. Corporate governance is needed to create a corporate culture of consciousness transparency and proper openness. Following the corporate governance policies helps a company to achieve its long term goal which can be seen in the terms of performance of a company. The stir surrounding corporate governance was created because of publication of an article in 1976. This led to research work in, 1970's and 1980's which were theoretical and empirical in nature, but it primarily focused on US corporations. The same kind of research work was undertaken by a lot of developed countries such as Japan, Germany and UK by the early 1990's. Soon the same kind of research revolving around corporate governance was made by the emerging markets such as India which was still developing.[24]

Corporate culture in India was very different as India was a colony to the British for 200 years'; the Britisher's were regulating the Indian market. So, mostly the corporate activities in India were derived from British corporate practices. After its independence in 1947, India tried to regulate its own market. From 1947 till 1991 Indian government practiced socialist policies which also included nationalization of banks. This kind of practice resulted in banks becoming the primary source of providing capital to all kinds of corporate businesses in India.

The government regulated the debt and equity market in India, firms and agencies which were associated with the government were encouraged to provide capital to private firms and were evaluated on the amount of capital provided rather than on return received on investment made. Private providers of debt and equity capital were discouraged, as the government had fixed the prices on which public equity could be offered to the public

[24] Jayati Sarkar & Subrata Sarkar, CORPORATE GOVERNANCE IN INDIA, Sage publishers, 2012.

which led to very less returns on investment, thus further creating obstruction in the path of private providers of debt and equity. The companies' act 1956[25], the listing agreement and accounting standards had set standards for disclosure and governance policies. The public companies were only required to adhere to the bare minimum of such standards providing them relaxations.

Financial crisis faced by India in 1991 led to economic liberalization. Now the Indian securities market was regulated by SEBI which was formed in 1992. The situation stabilized and Indian market started to grow. Halfway through the decade the economy started growing resulting in the Indian farms in need of equity capital. This led to the expansion of financial market to private firms and enterprises, which was limited to banks and government associated agencies acting as debt and equity capital and providers[26].

Liberalization led to change in behavioral pattern of the market, the demand for capital in market was increasing leading to corporate governance reforms in India. Many major corporate governance reforms were launched in India in mid of 1990's. All these initiatives launched focused primarily on improving the governance in corporate organizations.

2.2 **Codification of corporate governance in India**

The corporate governance practices in India derive their inspiration from the Anglo-American experience, literature and practice. The issues of corporate governance have been heavily debated in developed countries like the US and UK but these issues came to India later. India projects knowledge and inspiration for corporate governance norms from literature and practices established in the US and UK. The practice in India tries to focus on the same issue as of these developed countries and tries to offer the same solution.

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[25] The Companies Act, 1956, No. 1, Acts of Parliament, 1956.

[26] Kshama V Kaushik & Kaushik Dutta, INDIA MEANS BUSINESS: HOW ELEPHANT EARNED ITS STRIPES, pg 324 Oxford, 2012.

The first major initiative for establishing a code of corporate governance was taken by the confederation of Indian industry (CII) in 1998. The final document of code was titled as DESIRABLE CORPORATE GOVERNANCE: A CODE, this code contained detailed provision and focused on listed companies[27]. It was a welcome move adopted by many progressive corporate firms in India. The critique of this code was that it was voluntary in nature and had no deterrent to it, so something more than a voluntary code was needed. This experiment with the voluntary code was short lived and resulted in another initiative taken by SEBI in 1991. Therefore, Kumar Mangalam Birla committee was set up by SEBI in order to promote and raise the standard of good corporate governance in India.

The Kumar Mangalam Birla committee focused on issues such as presence of independent directors in the board and made recommendations on independence and representations of such directors in the board. The committee also emphasized on the importance of audit committee and made specific recommendations on composition, constitution and functions of board audit committee. These recommendations resulted in clause 49 of listing agreement of stock exchange which was ratified by SEBI in order to give effect to these key recommendations of the committee[28].

The third initiative was taken by the department of company affairs (DCA) under the ministry of finance and company affairs in August 2002. A committee was formed by his department known as Naresh Chandra committee[29] which gave some key recommendations on aspects of corporate governance such as financial and non financial disclosures and independent auditing and board oversight of management. This committee majorly focused on auditors and gift recommendations on matters such as grounds for disqualifying auditors from assignments that type of man audit services the auditor should be prohibited for performing and need for compulsory rotation of audit partners.

Clause 49 was similar to recommendations of the Cadbury committee report in the UK. The only difference was that clause 49 was mandatory in character. The violation of

[27] Corporate Governance: *Adopting the golden rules, Confederation of Indian Industries*, CII BLOG, (May. 4, 2020, 11:25 A.M), https://www.ciiblog.in/industry/corporate-governance-adopting-the-golden-rules/.

[28] *Preface to Report of the Kumar Mangalam Birla Committee on Corporate Governance*, NFCG, (May 5, 2020, 12:00 P.M.), http://www.nfcg.in/UserFiles/kumarmbirla1999.pdf.

[29] *Executive summary of Naresh Chandra Committee Report,* NFCG (May 5 ,2020, 3:00 P.M.), http://www.nfcgindia.org/executive_summary.html.

clause 49 would amount to breach of listing agreement that would result in delisting of the company. The stock exchange was hesitant to use such an option as it would be to the disadvantage of minority shareholders in the company. Exercising this option will deprive minority shareholders of liquidity in shares. This made SEBI set up Narayan Murthy committee headed by Mr. N.R. Narayana Murthy to review clause 49 and to suggest measures to improve the corporate governance standards in India[30].

Narayan Murthy committee like Birla committee also pointed out the fact that international development had motivated corporate governance reform in India. The failures in corporate governance especially in the US had indicated the need of further reforms in order to curb the failure of corporate governance. The committee was also of the view that the compliance of clause 49 had not been proper in India. The Narayan Murthy committee also examined corporate governance issues relating to corporate boards and audit committees as well as disclosure policies to the shareholders. The committee focused on the structure and role of corporate board 8 also strengthened the definition of director independence in clause 49 in order to address the role of insiders on Indian board[31].

The corporate governance reforms in India contain similar provisions as adopted outside this striking similarity is because the standards of corporate governance in India have been inspired by the Anglo American standards of governance which were considered by both Birla and Murthy committee.

Birla committee nets final report relied upon international experience and used the Asia stimulus for reform and a model for reform. The international standards and experience were considered by the committee because of high profile financial reporting even among firms in the developed economies. The Birla committee majorly followed corporate governance reports and codes followed and applied in the US and UK such as the report of Cadbury committee report, the combined code of London stock exchange and the committee on corporate governance in the US. Murthy committee did not explicitly follow any Anglo American standard for corporate governance. The Murthy committee report was affected by the huge corporate scandals like Enron and WorldCom, faced by

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[30] Smita Jain, *Corporate Governance — National And International Scenario*, ICSI.EDU (May, 6, 6:00 P.M.), https://www.icsi.edu/media/webmodules/programmes/33nc/33souvearticle-smitajain.pdf.
[31] Ibid.

developed economies like the US leading to enactment of Sarbanes-Oxley Act in 2002 in the US. This Act affected the corporate governance structure followed in the US and required the public companies to empower the audit committees, check the internal control measures and attach personal liability to directors and executives for accurate financial statements and make better disclosure policies. The similarity between 49 and living Anglo American corporate governance standards in particular the Cadbury report the OECD principles of corporate governance and Sarbanes- Oxley act 2002[32]. This reform led to strengthening of corporate governance norms in India. These reforms were responsible for substantive corporate governance properly supported by enforcement measures. This affected the corporate market in India with positivity as a proper structure to be followed was clear avoiding confusion and improving efficiency.

In order to strengthen the corporate governance norms SEBI was constantly making efforts. A committee under the chairmanship of Mr. J.J. Irani was formed, this committee summer today report which led to government of India's consideration to replace the companies act 1956.Based on the recommendations of Irani committee the government of India introduced companies bill 2008 in the Indian parliament. The proposed bill tried to enable the corporate sector in India to operate in an environment characterized by Best international practices encouraging entrepreneurship and investment. Owing to the resignation of the prime minister of India the 14th Loksabha stood dissolved in the year 2008 which led to lapse of the companies' bill 2008. This Bill was considered to be suitable for addressing various issues related to corporate governance so the government decided to re introduce the same bill as the companies' bill 2009 without any change[33].

The nation was jolted by the infamous Satyam computer services corporate governance scandal[34] in January 2009. It was a US dollar 1 billion scandal primarily caused by misstatements of the company's finances. This and other scandals acted as a catalyst for

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[32] Umakanth Varottil, *Corporate Governance in India: The Transition from Code to Statute*, SPRINGER (May 12, 2020, 3:00 P.M), https://www.springer.com/gp/book/9783319518671 .

[33] D. K. Prahlada Rao**,** *India: What Is New In The Companies Bill, 2008? - An Analysis*, MONDAQ (May 14, 2020, 10:00 A.M.), https://www.mondaq.com/india/directors-and-officers/77452/what-is-new-in-the-companies-bill-2008--an-analysis.

[34] Venture Global Engineering vs. Satyam Computer Services Ltd & Anr, 2010, SLP (Civil) No.9238 of 2010.

urgent reforms to be made in corporate governance norms in India. This scandal shook the very core of the corporate sector and securities market in India. The Government of India acted quickly which led to arrest of several insiders and auditors of Satyam by MCA and SEBI and substitution of companies' directors by government nominees.

After the news of the scam[35] broke the CII started to investigate various reasons responsible for such a big corporate governance scandal in India. The CII made recommendations for adoption of additional measures on a voluntary basis by the companies so that there is a balance between regulation and strong corporate governance norms.

The Government of India through ministry of corporate affairs promulgated certain voluntary guidelines for corporate governance norms in India. These norms contained additional corporate governance measures arising from lessons obtained by studying various corporate governance scandals happening in India. The resurgence of voluntary norms after making it mandatory was an effort to absorb the shock from various candles which disrupted the corporate market and created a crisis. The legislation in wake of such a crisis would have created unrest in the corporate market. Ministry of corporate affairs (MCA) in 2009 released the set of voluntary guidelines for corporate governance. These guidelines addressed issues of corporate governance like independence of board of directors, responsibilities of the board audit committee and secretarial audit and mechanism to encourage and protect whistle blowing. These voluntary guidelines were just baby steps to strengthen corporate governance[36].

This voluntary approach was not fruitful enough and did not long last. The company's bill 2009 was introduced in Loksabha, when the bell was pending before parliament it was referred to the standing committee for reviewing and to consult various stakeholders regarding their opinion on corporate governance norms. The standing committee after analyzing all the recommendations prepared a report which recommended a detailed corporate governance norm to be inserted in the companies bill. The recommendation included measures such as enhancing board independence, auditors' independence and other main shows like regulating party related transactions which tried to control the

[35] Ibid.
[36] Supra note 32.

stakeholders and management based on this report of the standing committee the government introduced companies bill 2011 in parliament[37]. However the same bill was withdrawn by the government and referred back to the standing committee for its consideration and recommendations. The standing committee made some recommendations which were incorporated in the Companies' Act 2013[38] which was ultimately passed by both the houses of parliament and received the assent of President of India on 31st August 2013. Proportion of legislation dealing with corporate governance norms had come in force since 1st April 2014[39].

The enactment of the 2013 act[40] brought major changes in approach towards corporate governance; there was a visible shift from voluntary approach towards slowly developing mandatory approach. The detailed corporate governance norms were being included in the primary legislation itself. SEBI was also working towards strengthening the corporate governance norms in India and hence the listing agreement was replaced by SEBI listing obligation and disclosure requirement regulations 2015 (LODR Regulations). These regulations replaced the requirement of clause 49. The new regulation dealt with the corporate governance matters. The LODR regulations brought stricter disclosure regime to the table which asked for timely and accurate disclosure of material information made available to all the stakeholders, equal treatment of all the shareholders either, minority or majority drawing a clear picture about the role of all stakeholders in the corporate governance, better and effective board supervision and management. The standard of corporate governance brought in by the new LODR regulations were higher than that contained in companies' act 2013[41]. These regulations try to protect the interest of small shareholders from acts of majority shareholders[42].

SEBI continuously acts as the regulator of corporate governance norms in India taking inspiration from the international development and trying to implement the same in India. SEBI in 2017 constituted a committee under the chairmanship of Mr. Uday Kotak to

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[37] Santosh Pandae & Kshama v Kaushik, *Study on the State of corporate governance in India*, CLOUDFRONT (May, 16, 2020,10:45A.M.), https://d1wqtxts1xzle7.cloudfront.net/33148684/Evolution_of_Corporate_Governance_in_India.pdf
[38] Companies Act, 2013, No.18, Acts of Parliament , 2013.
[39] Supra note 32.
[40] Supra Note 38.
[41] Ibid.
[42] Chandrajit Banerjee, *Corporate governance bar must be raised in India*, The Hindu, February, 27, 2020.

review the current corporate governance norms and recommend some policy changes and regulatory changes to strengthen the corporate governance norms for Indian listed companies.

Kotak committee submitted its report on October 5 2017 and made such recommendations so that the corporate governance structure in India is at par with the international standards of corporate governance with focus on local business practices in heron to India such as family run business or concentrated shareholding blocks which are not common in developed markets such as USA[43].

The report of Kotak committee was placed for public comments 4th November 2017 recommendations made by the committee area of corporate governance included the composition role and functioning of board of and its committee, oversight over a group entities and related party transactions, promoter related arrangements, enhancing transparency and disclosures, strengthening the financial reporting and audit oversight functions, investor engagement and participation and governance in public sector. SEBI accepted most of the recommendations of the kotak committee. The recommendations that have been accepted are being implemented through amendments to the listing regulations and other related guidance being issued by SEBI through its circular[44].

These amendments to the listing regulations will be applicable in a staged and slow manner. This gradual implementation of the amendments is done to give enough time to the listed entities to implement the changes and gather all resources required for the process. Most of these amendments are applicable from 1st April 2019 while some effective immediately. The amendments issued by SEBI to the listing regulations and disclosure obligation. The recommendation of the kotak committee has been roped into seven themes. The key changes under each of these themes are composition and role of the board, institution of independent directors, board committees, monitoring group

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[43] *Corporate Governance in Listed Companies: From the Abyss into the Sunshine*, BW, (May, 20, 2020, 5:00 A.M.), http://www.businessworld.in/article/Corporate-Governance-In-Listed-Companies-From-The-Abyss-Into-The-Sunshine-/09-01-2019-165987/.

[44] *Amendments to SEBI Listing Regulation pursuant to kotak committee recommendations*, KPMG (May 18, 2020 6:45 P.M), https://home.kpmg/content/dam/kpmg/in/pdf/2018/06/Amendments-sebi-listing-regulations.pdf.

entities and related parties, accounting and audit related matters, disclosure and transparency and investor participation[45].

April 2019 brought in amendments related to corporate governance framework in India. The resting obligation and disclosure requirement amendment regulations 2018 by SEBI came into effect in 2019.These amendments occurred at the time of various corporate governance controversies taking place in India like the ICICI bank-Videocon scandal, the infrastructure leasing and financial services defaults, the midterm resignation of don'ts for auditors of publicly listed companies and yes banks governance crisis[46].

The corporate firms in India are trying to incorporate and apply the practices of international corporate governance according to the knowledge such firms have regarding the policies prevalent in the international market. The practices that are followed by international corporate governance are not the actual values inherent to our culture. The implementation of such practices without modification is creating problems for the Indian corporate firms. The issues that arise because of implementation of such practices are affecting the behavioral patterns prevalent in the Indian firms. With the gradual changes in the structure of corporate governance in India and focus on the local business practices the proper corporate governance structure for India can be established just like the kotak committee tried to achieve[47].

Corporate governance in India has developed regressively from the past 20 years. The change in its structure from voluntary to mandatory, then shift from mandatory towards voluntary and in the end going back towards mandatory structure of corporate governance norms. India has come a long way recent developments enhance the regulatory structure of corporate governance which results in mandatory compliance by the companies. Independence of directors and a properly functioning audit committee is very beneficial for the stakeholders of the company and is going to result in profit for the company as well as the stakeholders. The disclosure policies help the stakeholders to make an informed choice about their investment rather than believe on hearsay or on somebody claiming to be a professional in the field of investment, this also helps to curb

[45]Medha Srivastava and Adamya Vikrant, India: Analysis Of Kotak Committee Recommendations On Corporate Governance (May, 20, 2020) , https://www.mondaq.com/india/corporate-governance/875864/analysis-of-kotak-committee-recommendations-on-corporate-governance.

[46] Ibid.

[47] Supra note 4.

insider trading from the company. A proper structure for smooth functioning of the company without any discrepancies in the management and to make sure that no ambiguities exist for the stakeholders strong corporate governance has to exist.

2.3. Corporate governance practices in India vs. the US and UK

Corporate governance has been a debated topic in the United States of America and Europe way before it became a topic of discussion in India. Corporate governance literature in India draws from the British and American literature on corporate governance there has been a tendency to focus on the same issues and look for the same solution. The example for the same can be taken from the code of corporate governance proposed by confederation of Indian industries was purely voluntary in nature that was modeled on the lines of Cadbury committee report from the United Kingdom[48]. Although this has been gradually changing this is evident from the Kotak committee's report in 2017. There are issues in Indian corporate governance that are very different from the issues prevalent in the US and UK.

Corporate governance literature in the US and UK focuses on the role of the board. Board of directors acts as a bridge between the owners and the management. In the scenario where the ownership and management become widely separated and there is no proper control of the owner over the management order the Board. The management executes the powers and functions itself without the owner's involvement and consent .The opinion of the board is itself influenced by the CEO. Corporate governance reforms in the US and UK focuses on making the board independent of the influence of the CEO and enables it to recruit independent and talented members. To make the role of the board more prominent there are nominations committee of the board being set up so that it can help in recruitment of talented, versatile and independent members. In order to control the compensations given to the CEO compensation committee it has been set up by many e

[48] Supra note 4.

companies so that they can check upon the amount of compensation being offered to the CEO is proportionate to performance[49].

A great amount of stress has been given to the role and function of the board in the US and UK. The corporate governance literature in the US and UK talks about the responsibility of the board to fire non-performing management personnel's and manage the position of CEO and its succession. A lot of stress has been given to the board committee specially the audit committees which not only handles the financial sports and health of the company but also acts as a system of check and balance against the financial frauds being committed in the company[50].

Corporate governance norms followed in India are driven from the literature of the US and UK but when he looked closely there seems to be a huge amount of difference in the practices that are followed in India. The prime focus for holding up the structure of corporate governance in the US and UK is given to the board and its importance and role whereas in India the ground reality is different. The conflict in the US and UK is between management and owners whereas in India the main conflict is between the dominant shareholder and minority shareholders. The corporate governance practices in India try to protect the minority shareholders interests and the board cannot even in theory resolve this conflict. The board even if given enough somewhere fields to discipline the management[51].

To develop better understanding of corporate governance practices followed in India. An analysis of different types of business sectors where different people are dominant shareholders is important. In the public sector undertaking, the dominant shareholder is the government and the general public holds a minority stake. In multinational companies where the parent company is based in a foreign country like uber based in the US, in this case the dominant shareholder is mostly the parent company so they are the dominant shareholders. In Indian business groups where the promoters together with their friends and relatives are dominant shareholders like the Ambani's in Reliance group.

[49]Jayanth Rama Varma, *Corporate Governance in India: Disciplining the Dominant Shareholder*, 9(4), IIMB Management Review, pg 518, (1997), (May,20, 2020, 2:00 PM) http://dspace.kottakkalfarookcollege.edu.in:8001/jspui/bitstream/123456789/72.

[50] Ibid.

[51] Supra note 4.

2.3.1. Public sector units (PSU'S)

Public sector units in India were initially state controlled and could be called state's enterprises. These undertakings could be said to be directly managed by the concerned ministry. PSU's were under the direct control of the administrative departments of these ministries. The functioning and management of these enterprises was directly controlled by the concerned ministry and the board didn't really have any important role to play in the functioning of the company.

Strengthening of corporate governance structure in India based on the model followed in US and UK the board had an important role to play but in India board had no role to play. The members of the board had very little say in the selection of the CEO or composition of the board. Government being the majority shareholder, all the decisions for the board through the concerned ministries with the help of public enterprise selection board. The board had no power to remove the CEO appointed by the ministry nor could vary the compensation given in proportion to the performance of the personnel. The audit committee had no say to what the CAG did[52].

The development of corporate governance norms had impacted the corporate governance structure of India for good. With the same view Central public sector enterprises (CPSE's) were listed. The listing was done to improve performance and competitiveness allowing them easier access to capital markets and making them more transparent and accountable.

The corporate governance norms applicable to the PSU's derive from the Companies act 2013, SEBI (Listing Obligation and Disclosure Requirement) Regulations, 2015 and CPSE guidelines issued by the Department of Public Enterprises under the Ministry of Heavy Industries and Public Enterprise. These guidelines were to be applied to listed CPSE'S; they had to follow all the provisions mentioned in the guidelines. The SEBI guidelines apply to them as well[53].

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[52] Supra note 48.

[53] *PSUs remain laggards in corporate governance*, The Indian Express, 6 June, 2019**,** (May 22, 2020, 11:00 AM) https://www.newindianexpress.com/business/2019/jun/06/psus-remain-laggards-in-corporate-governance-1986633.html

According to a report by proxy advisory firm stakeholder empowerment services (SES), 14 out of 48 PSU's survey were found to be following to proper guidelines for corporate governance. 22 PSU's were found not following guidelines issued with respect to composition of the board of directors, 17 creations feel to spend required amount on CSR activities. Non compliance of other guidelines such as: composition of audit committee, nomination and remuneration committee, not having an adequate number of independent directors. Failure to comply with the guideline stating that having at least one woman director on the board. A survey states that 27% of the NSE top 500 companies fail to comply with this requirement in March, 2019 which was to be followed from April 1, 2019[54].

Evaluating the rate of from the last four years two important areas company boards and women directors indicates that PSU is a moving towards improved compliance over the course of time. Still there are challenges and hindrances in achieving corporate governance in PSU and for the reforms will be needed for proper corporate governance to be achieved.

Exemptions are being provided to the government companies that are used by the government under section 462[55] of the Companies act 2013 which provides power to the government to exempt class of classes of companies from provisions of companies act 2013. According to section 462[56] such exemptions can only be provided in Public interest. Although, diluting the governance norms will only make public interest a farfetched goal. This differential treatment is only received by PSU's and not the private companies.

The amendments made to LODR regulation by SEBI after Kotak committee recommendations brought a new corporate governance structure. The committee even made commendations to provide more autonomy to PSU and reduce the dependence on administrative ministry to ensure speedy decision making, function and operational autonomy, attain commercial goals and attract talent. After applicability of the capital market regulator is new corporate governance laws stock exchange have revealed penalty over a dozen of public sector undertakings for not complying with the board and

[54]Ibid.

[55] Section 462, Companies Act, 2013.

[56] Ibid.

dependent director requirements. Some of the leading PSUs like HPCL, NHPC, and Bharat dynamics have declined to pay the fines and contended that they are state owned companies and have power to make any board appointments and should not be subject to fine. According to legal experts the new corporate norms by SEBI are in conflict with the laws applicable to PSU. For example every company needs to have a nomination and remuneration committee which provides the remuneration after evaluating the performance. However in case of PSU the board appointees are technically picked by the president of India, so it will be very difficult for such a committee to be able to review the board performance[57]. There is resistance offered by PSU's against the new notified corporate governance rules in October last year based on the recommendation of Kotak committee headed by Uday Kotak on corporate governance.

Corporate governance practices followed by the corporate business places in India are evident enough to show that the practices followed in the US and UK is different from corporate governance practices in India.

2.3.2. MNC's

Multinational companies in India are allowed to operate through subsidiaries which are not 100% owned by the parent company. For example Microsoft India private limited is a subsidiary of American Software Company Microsoft Corporation headquartered in Hyderabad in India. Indian economy was stringent in the beginning and allowed only 40% foreign ownership and 51% in high technology areas. With liberalization the Indian economy loosened up changes in FDI policy the percentage of ownership increased to 100% some areas[58].

In the 70's the MNCs were forced to issue shares to Indian public to comply with the law. The pricing control on public issues exercised by the government at that time meant that the public issues were available at discount to the market price. In the 90s when higher foreign ownership was allowed the MNCs tried to raise their foreign stake by offering public issues at very high discounts then the market price resulted in huge losses to the

[57] Listed PSU's- Governance Gaps, SESGOVERNANCE, (June,10,2020, 2:30 P.M), https://www.sesgovernance.com/pdf/home-reports/1542262686_Listed-PSUs---Governance-Gaps.pdf

[58] Supra note 48.

minority shareholders. The public issues were made with the consent of the shareholders in the general meeting. The parent company being the dominant shareholders easily got the resolution past in the general meeting. The government trying to control this type of behavior and exploitation of minority shareholders introduced new regulations to prevent issues of such allotment of preferential shares. These regulations were protested by their MNC's claiming it an assault on shareholder democracy.[59]

The MNC's are trying to exploit the minority shareholders by transferring the profitable brands and businesses to new form subsidiaries at artificially low prices. This leads to loss for minority shareholders who have contributed to the company through investment made in its capital and build up its business.

New corporate governance norms are trying to incorporate transparency and accountability to the board so that the minority shareholders interests are being protected in the company.

2.3.3. The Indian Business Group

These companies are defined by the dominant shareholders; the situation is complex as the shareholding is spread across several friends and relatives as well as corporate entities. The promoters of the company are generally relatives; friends are family members or people associated with them. Promoters mean the dominant shareholders of the company try to influence almost all the management and functional decisions of the company like structure of the business, transfer of the assets between companies, preferential share allotment so the dominant shareholders etc.

Dominant shareholders were influencing the decisions of the board. They had a majority so passing any resolution they wanted in the annual general meeting was not a problem. There was very less transparency and accountability owing to these permanent shareholders. There were instances when the transactions took place purely in cash and there was no record of it in any of the books. Due to lack of transparency the minority shareholders were shown such a picture of business which was actually different from reality.

[59] Ibid.

Indian business groups were mostly family businesses. The changes in the corporate structure over a period of time are gradually leading to a change in the business structure of the Indian business groups. The requirement of independent directors, audit committee, independence of the audit committee and auditors , many other regulations issued by SEBI per in order to incorporate transparency and accountability in the corporate structure of a business and protect the minority shareholders interest against the dominant shareholders interest who try to influence each and every decision of the business

After analyzing the corporate structure of PSU's, MNCs and Indian business groups it is quite evident that the corporate governance practices in India are different from the corporate governance practices in UK and US. The major issue in India is not conflict between ownership and management but a conflict between dominant shareholders and minority shareholders. The kotak committee recommendations have kept in mind the local conditions prevailing and then suggested measures in the report for reforms in India that will lead to you better and strong corporate governance norms in India.

CHAPTER 3

CORPORATE GOVERNANCE FAILURES

The concept of corporate governance has now become very familiar among Indian corporate houses. It was a newer concept in the nineties and was heavily debated upon by developed economies like the USA and UK but with gradual development the concept started gaining familiarity, regular reforms and development has made it a better and stronger concept.

Corporate governance begins with power, one who holds the power and uses of such power. With power comes great responsibility to make the right decision, choose to delegate to the right person and control of such power, in a way that's best for the organization. Power in corporate organization is not absolute. It comes with restraints and is exercisable well within the ambit of guidelines. Corporate governance failure begins with misuse of the power provided although failure does not happen in a day; it happens gradually as the governance system crumbles slowly and brings the corporations to ground.

Corporate governance has been gaining prominence from the last two decades in India, trying to come at par with the international standards, setting up committees, reforming the code structure and strengthening the corporate governance code in India. The momentum gained by corporate governance is because of corporate governance failures, unethical business practices and insufficient disclosures.

Corporate governance failure happens when the management undermines the role of various governance structures by overpowering all the other internal controls and making misrepresentations to the auditors and the board. It can also be a result of ignorance of auditors, regulators, analysts i.e. the authorities who act as a checks and balance system in an organization against the arbitrariness exercised by people in power. There are red flags before the complete collapse; these warning signs should be picked up by the organizations before it leads to corporate governance failure. .Some of the governance issues faced by the firms which eventually lead to corporate governance failures are –

- Ineffective governance mechanisms, for example, lack of board committees or committees consisting of few or a single member.
- Non-independent board and audit committee members, for example where a CEO fulfilled multiple roles in various committees
- Management, who deliberately undermines the role of the various governance structures by circumventing the internal controls and making misrepresentations to auditors and the Board.
- Inadequately qualified members, for example, audit committee members not having appropriate accounting and financial qualifications or experience to analyze key business transactions, family members holding board positions without appropriate knowledge or qualifications.
- Ignorance by regulators, auditors, analysts etc of the financial results and red flags. The evidence of corporate failure owing to auditor ignorance can be found in India as well as abroad[60].

3.1. THE ENRON SCAM

In 2001 the wall street of America was shocked to see the fall of one of the biggest American giants, Enron. The US energy, commodities and service company Enron Corporation declared bankruptcy in 2001; it was one of the biggest bankruptcy filings in the history of the US. The role of the auditor Arthur Andersen and Company in approving the Enron’s books was misleading. Investors including Enron's own employees had invested thousands of dollars in the company believing in the profits reported. The support of the auditor for not standing up against the incorrect led them to land in a soup themselves. The auditing and accounting firm became subject of Justice Department investigation, Congressional enquiries, and lawsuits from shareholders over its stamp of approval on Enron's books. This scandal even led to dissolution of Arthur Andersen LLP which was the largest auditing and accounting company in the world[61].

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[60] *How does corporate governance failure impact your business*, BLOG V COMPLY, (June 12, 2020, 10:04 AM), https://blog.v-comply.com/corporategovernancefailure.
[61] *Enron scandal*, CORPORATE FINANCE INSTITUTE (June15, 2020, 10;20 AM) https://corporatefinanceinstitute.com/resources/knowledge/other/enron-scandal.

The Enron scandal raised serious questions about the independence and efficacy of auditors. The auditors have relied more upon consulting work rather than relying upon traditional audits for revenue, thus bringing up issues such as improper bookkeeping. The auditors lost all the ability to stand up to clients in case of improper bookkeeping in fear of losing the most important client i.e. the Enron Corporation. It is evident enough that Andersen who was the auditor has acknowledged that Enron is one of the biggest and most desirable clients. After the Enron scandal rocked American market and the whole world, a code of legislation followed in the US to increase the accuracy of financial reporting for a publicly traded company. The most important of these measures was the Sarbanes-Oxley Act 2002. This act embodies harsh penalties for destroying altering or fabricating any financial records. The SOX Act mainly dealt with auditor's independence and financial disclosures.[62]

The world was progressing in creating a strong corporate governance structure while India was lagging behind. When in 1992 the reform of SEBI happened it led SEBI in control and supervision of stock trading activities. SEBI also formed many corporate governance rules and regulations. Then in 1996 a voluntary code was introduced by Confederation of Indian Industry (CII). The nature of voluntary code was such that it was not being followed properly. Then SEBI constituted two committees in Kumar Mangalam Birla and Narayan Murthy committee, in 1999 draft code of corporate governance practices in India. Based on the recommendations of these committees Clause 49 was introduced so that standards of corporate governance can be raised. In 2008 on recommendations of J.J. Irani committee the government of India considered to replace the Companies Act 1956. Acting on the recommendations of the committee the government of India introduced the companies' bill 2008 in Indian parliament. Due to political unrest in India the Loksabha was dissolved after the prime minister resigned. The bill lapsed owing to the dissolution of Loksabha; it was introduced again in the year 2009 without any change[63].

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[62] Reed Abelson and Jonathan D. Glater, *Enron's Collapse: The Auditors; Who's Keeping the Accountants Accountable?*, The NY Times, Jan 15, 2002, (June 16, 2020) https://www.nytimes.com/2002/01/15/business/enron-s-collapse-the-auditors-who-s-keeping-the-accountants accountable.html.

[63]Afra Afsharipour, Corporate Governance Convergence: Lessons from the Indian Experience, 29 Nw. J. Int'l L.& Bus. 335 (2009) (June 16, 2020) https://heinonline.org.

3.2. THE WATERSHED SCANDAL OF INDIA

In the year 2009, the whole nation stood shocked with the biggest scandal in the history of India. The Satyam scam shook the very core of the corporate governance structure established in India. Satyam Computer Services Limited was founded by Mr Ramalinga Raja 1987 in Hyderabad. It was an Indian outsourced IT- services industry, offered IT and business process outsourcing service spanning various sectors. Satyam won many awards for innovation, governance and corporate accountability. It even won the prestigious Golden Peacock National Award for excellence in corporate governance in 2002.[64]

In 2003 Satyam computers were growing very fast and it was becoming the star of the IT marketplace in India. The contributing factor to this growth was the growing IT market worldwide. The importance of IT services to the business world wide has increased significantly after the impact of the internet on e business. The need for such IT Industries in India increased that could provide services according to the growing need of them in the market. Business of satyam computers grew rapidly, the share price increased by 300 % from 138.08 INR to 526.25 INR in five years. The company was recognized in the global IT marketplace and had gained a number of shareholders and grew significantly in the corporate marketplace[65].

Satyam was riding on success and became the fourth largest software company in India. The company even won the prestigious Golden Peacock Global award for excellence in corporate governance in 2008. This award was bestowed upon Satyam computers by the UK based World Council for Corporate Governance. The company became a crown jewel for India[66]. In January 2009, the disclosure made by the chairman and founder of Satyam computers Mr.Raju Ramalinga to Satyam computers limited board of directors about the manipulation in companies accounts for number of years. He confessed about

[64] S. Agrawal and R. Sharma, *Beat This: Satyam Won Awards for Corporate Governance, Internal Audit*, VCCircle,2009(June 16, 2020, 3:00 AM), www.vccircle.com/news.
[65] Madan Lal Bhasin, *Corporate Accounting Fraud: A Case Study of Satyam Computers Limited*, 2, OJAcct, 26-38, 2013, (June 17, 2020, 4:00 AM), http://www.scirp.org/journal/ojacct.
[66] *Satyam stripped of Golden Peacock award 2008*, ET, Jan 7 2003, (June 18, 2020, 4:00 PM) ,economictimes.indiatimes.com.

the overstated assets, on existent cash in the balance sheet, the unreported liabilities and overstating income in every quarter to meet the analyst expectations. The company's global head and head of internal audit used a number of techniques to commit such fraud like the head of the internal audit created fake customer identities and generated fake invoices against their names to inflate revenue[67]**.** The fraud came into light when Satyam planned to acquire 51% stake in maytas infrastructure limited which was the leading infrastructure development construction and project management company. The maytas infrastructure limited was managed by Raju Ramalinga family and he himself had stakes in the company. The proposal to acquire stake in maytas infrastructure limited was approved by the Satyam board which included five independent directors who approved the proposal. This decision of acquisition was taken without shareholder approval therefore the investors sold the Satyam stock and threatened to take action against the management. The decision of acquisition was reversed within 12 hours after investors sold Satyam stock and threatened action against the management. Dress rehearsal of acquisition led to a number of lawsuits filed in the US contesting maytas deal. The World Bank banned Satyam from conducting any business for a period of 8 years because of inappropriate payment to the staff and inability to provide justifications sought on invoices[68]. For independent directors quit the Satyam board hours after incident meanwhile SEBI to disclose pledged shares to stock exchange. It was disclosed by Mr. Raju that the gap in the balance sheet had arisen because of constant inflation in profits over a long period of time that could be dated back to 1999. The acquisition of maytas infrastructure was a move to cover up this gap and keep high earnings per share and make huge profits by selling stock at higher prices.[69]

The auditing fraud that was committed at Satyam computers amounted to whopping thousands of crore of rupees. The scam was so big that it was labeled as India's Enron by the analysts[70]. The disclosure made by Mr. Ramalinga was just four months after the bestowment of prestigious Golden Peacock global award. The irony of the situation was

[67] *Satyam: Investigators look into the role of internal audit team*, ET, Jan 21, 2009, (June 19, 2020, 8:00 AM) https://economictimes.indiatimes.com/tech/software/satyam-investigators-look-into-the-role-of-internal-audit-team/articleshow/4009228.cms?from=mdr.

[68] Supra note 65.

[69] Ibid.

[70] *India's own Enron scandal: Analysts*, ET, 7th January 2009, (June 20,2020, 9:23 AM) https://economictimes.indiatimes.com/.

such that the award was given for excellence in corporate governance and the scam was the result of failure of corporate governance.

3.2.1 Auditors Role

The prestigious auditing firm PricewaterhouseCoopers (PwC), this global auditing firm was responsible for auditing Satyam computers accounts from the year 2000 till 2009. The role of PWC in contributing to the fraud is inevitable; the firm audited books of satyam for 9 years and never even suspected any misstatement in the books of the company. PWC signed the financial statements of the company and was responsible for the figures represented in those books under the Indian law. The fraud at Satyam went on for a number of years where manipulation of balance sheets and income statements was involved. The creation of fictitious assets in order to show more income was done a number of times without the auditors even noticing it once. The cause for even more suspicion was the payment made to PWC by Satyam was double the amount that other auditing firms charged for conducting the audit. Role of auditors came more into question when Merrill Lynch discovered the fraud within 10 days with due diligence that PWC would not even doubt in 9 years. Missing these red flags implied either gross negligence on part of auditors or that they were aiding the company in committing the fraud[71]. .

The investigation that followed after the revelation of the fraud led to arrest of people involved in fraud associated with satyam computers. Indian authorities arrested the global head of Satyam Mr. Raju Ramalinga, his brother B Ramu Raju who was the former managing director of the company, the head of internal audit Srinivas Vdlamani, and chief financial officer of the company on criminal charges of fraud. Even some of the auditors from the firm Tech Mahindra were involved, Satyam CFO also arrested. Institute of chartered accountants of India ruled that the CFO and auditors were guilty of

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[71] Surya R Kannoth, *Satyam fraud puts auditors' role under scanner*, ET, 7th Jan, 2009, (June 21, 2020, 1:00 PM) https://economictimes.indiatimes.com/tech/software/satyam-fraud-puts-auditors-role-under-scanner/articleshow/3948237.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cppst.

misconduct[72]. There were a number of civil and criminal litigation against Satyam in India and a number of civil litigation in the US also.

The fate of Satyam was sealed for the worse but intervention of Indian government saved it from same fate as Enron faced in the US. The Government of India tried to save the company and appointed a new board of directors for Satyam, this new board of directors appointed was suppose to sell the company within hundred days. The board worked to instill confidence of the market in Satyam Corporation so that other IT companies participate in the auction process for Satyam seeing its improved market reputation. SEBI overlooked this auction process to ensure transparency. The highest bidder Tech Mahindra bought Satyam in auction and Satyam became a subsidiary to Tech Mahindra. SEBI and Tech Mahindra are now fully aware of the full extent of the fraud that was committed at satyam and decided not to pursue any further investigations against Satyam Computers and it became a part of business of Tech Mahindra[73].

The satyam scandal was an eye-opener for the nation and was followed by the enactment of Companies Act, 2013. There were many measures taken for strengthening the legal structure of corporate governance in India but none seemed to work here in this case. The series of the fraud owing to corporate governance failure involving the role of auditors continued. Another noteworthy example of fraud nine years after satyam was the fraud that happened at the Punjab National Bank.

3.3. THE PUNJAB NATIONAL BANK SCAM (PNB SCAM)

The humongous 12000 crore scam by Punjab National Bank grabbed headlines all over the media. The scam was unearthed in the month of February when PNB declared a fraud within their system which was a result of a fraudulent letter of undertaking (LoU) issued by the bank. The term letter of undertaking is a guarantee provided by one bank to another in favor or on behalf of a customer. It is used by a bank's customer to avail short term credit in a foreign country. This kind of transaction is mostly undertaken by

[72] ICAI, *ICIA Finds ex Satyam CFO, Price Waterhouse Auditors Guilty*, Outlook, 2009.
[73] John Satish Kumar, Tech Mahindra, *Satyam get nod to merge*, LIVEMINT, (June 18, 2020 6:00 AM) https://www.livemint.com/Companies/3gvuJGAgAumXazCDQ4otRO/Tech-Mahindra-Satyam-get-nod-to-merge.html.

businesses for import of goods. The borrower uses an existing credit relationship with the bank in India to avail credit outside the country[74].

The scam first started coming out when PNB filed a complaint with CBI on 29 January 2018 against fraudulent transactions with Nirav Modi's firm. This was followed by PNB informing the stock exchange on 14th February 2018 regarding the fraud amounting to $ 1.77 billion[75]. The fraudulent transactions or the LoU without mortgage had been issued at Mid Corporate Branch Brady House, Mumbai by employees at the branch. These employees at PNB issued fake letters of undertaking which would lead to the bank account that PNB had in another bank in foreign country, this account is called NOSTRO account. The NOSTRO account of PNB was used to fund overseas short term credit taken by customers of the bank including fraudsters like Nirav Modi[76].

The letters of undertaking which were issued by the bank were used by the fraudsters to acquire goods at the expense of PNB, without requirement of any collateral security as mortgage to secure the credit outside India. When the time to repay the previous LoU came these people used the same tactics and repaid the loan by securing another short term credit loan at the expense of PNB. Their businesses were running unhindered because they relied upon the LoU issued to them by the bank. It was the bank that was suffering because the fraudsters were using the bank's fund to run their own businesses. The main accused in the scam is jeweler and designer Nirav Modi, his maternal uncle Mehul Choksi, some of other relatives and some PNB employees. Nirav Modi and his family fled the country before this scam came out in the open. The bank was stuck in the vicious cycle of this short term credit which the customers use to fund their own businesses without fear of any penalty or loss in default of such payment. This fearlessness was because the LoU issued by PNB was without any collateral and in case of default the bank becomes liable to pay from their pockets[77].

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[74] Shaikh Zoaib Saleem, De-jargoned: Letter of undertaking, ET, 22feb 2018, (June, 20, 2020, 7:00 PM) www.livemint.com.

[75] Gayathri, S., & Mangaiyarkarasi, T, *A Critical Analysis of the Punjab National Bank*, Int. J. Pure. Appl. Math, 119(12),14857, (2018), (June 21, 2020, 8:00 AM) https://acadpubl.eu/hub/.

[76] Roy , A., Kalra, A., & Rocha, E. *How PNB fraud happened: A 162-page report lays bare the lapses*, LIVEMINT, (2018, June 21), (June 20, 2020, 6:00 PM) www.livemint.com,https://www.livemint.com/Companies/QVrxBXaZBX2t82KkFBSAOL/How-PNB-fraud-happened-A-162page-report-lays-bare-the-laps.html.

[77] *WHAT IS PNB SCAM* , Business Standard,(June 21, 2020, 11:00 AM) https://www.business-standard.com/about/what-is-pnb-scam.

3.3.1 Role of Auditors

The PNB scam did not happen in a day or was a result of an isolated incident. It takes time to commit fraud of such a big amount. This scam hints about the role of auditors and the failure of operational risk management. A great amount of suspicion arose because such a massive scam went undetected and resulted in such a huge fraud of twelve thousand crore rupees. Both senior and junior officials of the branch have been questioned in relation to the unauthorized transactions taking place resulting in fraud of such a huge amount[78].

Corporate governance is a system by which organizations are controlled and directed. Smooth functioning of daily operational activities depends upon corporate governance. Although the board of the company is its backbone, the values enshrined in a company are as set by the board. In the same way corporate governance structure has to be followed by public sector banks as well to ensure transparency and efficient working like well oiled machinery. There are issues that need to be considered in case of corporate governance in public sector banks such corporate governance issues have been highlighted specifically in the PNB scam.[79] PNB is a listed entity, so it has to adhere to regulations by SEBI As per section 177 of Companies Act, 2013[80] and Rule 6 of Companies (Meetings of Board and its Powers) Rules, 2014[81]. According to these laws and regulations the board has to constitute an audit committee to ensure effective monitoring of the financial statements. The audit committee also has to ensure the integrity of the company's accounting and financial reporting systems including independent audit and putting in three separate systems of control for risk management, financial and operational control and compliance with the law and relevant standards.

Audit committee should be formed in consonance with the rules and regulations laid down by SEBI and the companies' act 2013. Audit committee shall consist of a minimum

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[78] Bharadwaj,S Nirav Modi case: PNB *fraud affects stocks of Union Bank, Allahabad Bank, SBI, Axis, Bank,* BUSINESS TODAY, (2018, March 22), (June 22, 2020, 4:45 PM) www.businesstoday.in:https://www.businesstoday.in.

[79] Dr. Ajay Kumar, *PNB Scam: A corporate governance failure,* DELHI POST, (June 18, 2020, 10:00 AM) https://delhipostnews.com/pnb-scam-corporate-governance-failure/.

[80] Section 177, The Companies Act, 2013

[81] Rule 6 of Companies (Meetings of Board and its Powers) Rules, 2014

of three directors as members and 2/3rd of the members shall be independent directors including the chairman. The compulsory requirement of the chairman of the committee to be financially literate and at least one member of the committee shall have expertise in the field of accounting or related financial management expertise.[82] These laws and regulations were made to ensure the audit committee works efficiently and detects any discrepancies in the financial statements of the company.

These norms of corporate governance were flouted by the Punjab National Bank. The audit committee acts as a check against any financial arbitrariness committed, its independence and efficacy are super important for transparency in financial statements and to detect any misstatement in the books. The standards of composition of the audit committee were compromised by the Punjab National Bank. Documents of the bank show that the audit committee was well aware of the weak audit and scrutiny system[83].

For a period of two years between 2015 and 2017 the audit committee of PNB did not have an adequate number of independent directors as board members which is a mandatory requirement in composition of the committee[84]. The annual reports of PNB have findings that the audit committee was not headed by a person having knowledge of accounting and financial management expertise. The transactions that took place without any collateral were unidentified the last six years. There are sets of auditors in a public sector bank like PNB. The concurrent auditor who is supposed to report to the main branch, the internal auditors and the statutory auditors and finally auditors of reserve Bank of India and still such a huge fraud happened under their noses[85].

The ministry of corporate affairs filed for removal of auditors under on the ground of fraud the matter was taken to National Company Law Tribunal Mumbai. In the matter of the Union of India, Ministry of Corporate Affairs ('MCA') vs. Mr. Mukesh Choksi and Zen Shavings Ltd. NCLT allowed an application filed by MCA under section 140(5) of the Act for removal of the Company's Auditor. This article tries to analyze the scope of

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[82] Section 177 of Companies Act, 2013 read with Regulation 18 and Part C of Schedule II of SEBI (LODR) Regulation, 2015.

[83] Supra note 79.

[84] Supra note 80.

[85] Aruna Roy & Joydeep Ghosh, *Nirav Modi PNB fraud: How bank auditors failed to detect scam in 6 years,* Business Standard, February 20, 2018,(June 24,2020, 12:00 PM) https://www.business-standard.com/article/finance/pnb-fraud-how-bank-auditors-failed-to-detect-the-scam-in-six-years-118021901425_1.html.,

section 140(5) and the grounds on the basis of which an Auditor of a Company can be removed under the said section[86].

Such a huge fraud could have been detected at least by one of these auditors but the scam certainly points in the direction of inefficiency of auditors to detect fraud in case of PNB. After the PNB scam, the government got alerted as public sector banks had sovereign guarantees which brought the government directly into picture. This led to the enactment of an autonomous and independent body NFRA which had been pending for a long time. The PNB scam acted as a catalyst for better regulations to enhance corporate governance standards. But the IL&FS scam unveiled itself after the PNB fraud can be called the biggest scam in the history of scams.

3.4. IL&FS SCAM

IL&FS stands for infrastructure leasing and financial services. It is a non banking financial institution that was established in 1987 as an RBI registered core Investment Company. Initially it was promoted by Central Bank of India, Housing Development Finance Corporation (HDFC), and Unit Trust of India (UTI). This company has inducted institutional shareholders such as State Bank of India, Life Insurance Corporation of India, Orix Corporation of Japan and Abu Dhabi Investment Authority. This company gives loans and advances to its group companies and also holds investment in such companies. IL&FS has a large number of the company of group companies across various factors such as energy, transportation, financial Services etc[87]. IL&FS group faced severe liquidity crisis, two of its subsidiaries reported having trouble in paying back loans and deposits to banks or lenders between July 2018 and September 2018. One of the subsidiary of IL&FS group could not pay a short term loan which amounted to thousand crore, this loan was taken from small industries Development Bank of India (SIDBI). There were certain other subsidiaries unable to pay debt taken. The resulted in

[86]Union of India, Ministry of Corporate Affairs (‘MCA’) vs. Mr. Mukesh Choksi and Zen Shavings Ltd, 2019, [LSI-3-NCLT-2019(MUM)],

[87]*Who are we, IL&FS*, (June 23, 2020, 10:00 AM,) www.ilfsindia.com.

IL&FS group being neck deep in debt. The corporation stood upon a debt amounting to rupees 91000 crore at the end of October 2018[88].

The Government of India acted swiftly fearing the meltdown of the financial sector because of a liquidity crisis amounting to almost 1 lakh crore rupees. The government seized control of the IL&FS group in order to control the panic that has been created because of the liquidity crisis. The government superseded IL&FS under section 241 of the Companies Act 2013. This section empowers the government to suppress the company's board in case of mismanagement by the board in order to protect the interest of the public[89]. Ministry of Corporate affairs had filed a complaint with NCLT under the same section[90] in order to overtake the board and replace it with the nominees appointed by the government. Kotak Mahindra Bank, vice chairman and managing director Uday Kotak, Tech Mahindra vice chairman, managing director and CEO Vineet Nayyar, former SEBI chief G N Bajpai, former ICICI bank chairman G C Chaturvedi, former IAS officer Malini Shankar and Nand Kishor were made members of the board[91].

3.4.1 The role of auditors

The Serious Fraud Investigation Office (SIFO) started investigation into the liquidity crisis caused and found major procedural defaults at IL&FS. The vice chairperson of the company Mr. Hari Shankaran was arrested by SIFO for granting loans to entities that were not worthy of giving credit to and which led to huge losses to the company. The investigation done by SIFO also found problem with the audit done by Deloitte of the accounts of IL&FS.

The disciplinary directorate of Institute of Chartered Accountants of India (ICAI) took suo motu cognizance of the matter and investigated the performance of statutory auditors appointed by IL&FS. The ICAI found some misstatements, manipulations in the financial

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[88] *Has IL&FS defaulted on 10 billion short-term loan from SIDBI*, Business Standard, September 5 2018,(June,24,2020, 2:00 PM) https://www.business-standard.com/article/companies/has-il-fs-defaulted-on-rs10-billion-short-term-loan-from-sidbi-118090500666_1.html.

[89] Section 241,The Companies Act, 2013.

[90] Ibid.

[91] Piyush Joshi, *the Government takeover of IL&FS is unlike Satyam's: here is why*, MONDAQ, (June 23, 2020, 1:00 PM), https://www.mondaq.com/india/corporate-and-company-law/743970/the-government-takeover-of-ilfs-is-unlike-satyam39s-here-is-why

statements audited by statutory auditors. The ICAI held statutory auditors of IL&FS prima facie guilty of professional misconduct[92].

SIFO has filed charge sheet against 30 parties that includes two auditing firms for criminal conspiracy and misreporting the financial statements of IL&FS group. Ministry of Corporate affairs has also moved against the audit firms that include Deloitte Haskins and Sells as well as BSR and associates LLP and the former auditors of the firm. MCA filed complaint under section 140(5) of Companies Act in NCLT and sought debarment of auditors for the role played by these auditors in aiding the fraud at IFIN a subsidiary of IL&FS group. The move of MCA was followed by a series of litigation filed by the auditors and MCA in Bombay High court and supreme court of India.[93]

In the matter of BSR and associates LLP and anr vs. Union of India and anr, 2019 The Bombay High court granted relief to BSR and associates LLP and Deloitte Haskins and sells the former auditors of IL&FS financial services. BSR part of KPMG India and Deloitte had moved Bombay High court in 2019 challenging the validity of the plea filed by MCA before the Mumbai bench of NCLT seeking the removal of auditors of IL&FS under section 140 (5) of the Companies Act which would result on 5 year ban on these audit firms after being removed by the mandate of section 140 (5). The NCLT approved the government's plea and removed the abovementioned auditors. Aggrieved by the order of NCLT the audit firms reach Bombay High court and challenge to the validity of section 140(5). Bombay High court quashed the prosecution of both the firms by NCLT and upheld the constitutional validity of section 140 (5). The high court also quashed the criminal complaint filed by serious fraud investigation office for financial irregularities on the ground of being bad in law. Order of High court was challenged by The Ministry of corporate affairs in Supreme Court of India but the apex court refused to stay the order of the High court[94].

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[92] Shashank Pandey, *Explainer: The IL&FS insolvency case*, BAR AND BENCH, (June ,26,2020 1:00AM) https://www.barandbench.com/columns/ilfs-insolvency-the-journey-so-far

[93] Rashmi Rajput, *MCA plans to move SC against IFIN auditors*, ET, April, 25, 2020, (June 26, 2020, 4:00 PM) https://economictimes.indiatimes.com/industry/services/consultancy-/-audit/mca-plans-to-move-sc-against-ifin-auditors/articleshow/75361119.cms?from=mdr.

[94] BSR and Associates LLP And Anr vs. Union of India on 21 April, 2020.

In corporate scam cases the first one to be blamed are auditors for not detecting the fraud. The role of the auditors in corporate governance failures can be major owing to the duty of auditors to ascertain proper financial management and detect financial irregularities. The role played by auditors in case of Satyam, PNB and IL&FS is proof enough to allocate a major portion of responsibility for the fraud upon the auditors. The failure of the auditors can be related to their independence in an organization, the independence of auditor in a company helps him/her to work more efficiently without any influence. Many measures have been taken in recent times to ensure independence and improved efficacy of the auditors and to curb financial frauds from happening because auditors lack independence and authority.

CHAPTER 4

DEVELPOEMENT OF ROLE OF AUDITOR AND AUDIT COMMIITEE

Corporation is a body of various stakeholders, customers, employees, investors, vendor partners, government and society. This Corporation is managed smoothly by following corporate governance norms. Corporate governance sets norms facilitating regular day to day functioning of any company; following these norms a corporation is bound to benefits all the stakeholders. In a way it can be said that corporate governance roots for the greatest good for all the stakeholders. The Corporate governance structure acts as a bridge between the Management and shareholders because the ownership and management are controlled by different people. The shareholders are the owners and management being in control of business and day to day functions of the corporation. Corporate governance involves balancing the interests of all stakeholders, to ensure a good system of corporate governance that enhances greater transparency and accountability[95].

Auditors are such an agency which allows the shareholders to get a transparent and correct analysis of the financial statements of the company. Auditors can be called a tool in the corporate governance structure that increases transparency and accountability of a company towards its stakeholders. Various corporate scams like Enron, Satyam around the globe and in India shook the investor confidence completely. Corporate governance was used to regain the trust of investors, through auditors and audit committees ensuring the reliability of financial statements of the company. Auditors are of two types internal and statutory i.e. external. To monitor the auditors sub-committee is established by the board called the audit committee. An Audit committee is established to oversee the financial and accounting process in a company and help the board of directors discharge their financial responsibilities properly.

Corporate Governance structure has been developing for the last two decades to become stronger for early detection of frauds like Satyam, Enron, and WorldCom etc. The role of

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[95] Dey, *Aiyesha, Corporate Governance and Agency Conflicts*, 46(5), J. Account. Res, 1143, 1143-81, 2008, JSTOR, www.jstor.org/stable/40058121

auditors in these scams was very prominent and to strengthen the corporate governance structure development of the laws and regulations related to auditors and audit committee was required. To understand the present scenario involving the role of auditors and audit committee tracing its development is necessary. In India the development of the role of auditors can be divided into two major time frames the pre Satyam scam era and the other post the scam. India saw some major changes in rules and regulations relating to auditors and audit committees.

4.1. AUDIT COMMITTEE BEFORE SATYAM SCAM

The requirement of audit committees for all listed companies in the USA was made mandatory by the New York stock exchange as early as 1978.[96] Many cases of corporate governance failures were taking place all around the globe and numerous reports concerning misappropriation, fraud, and mismanagement in functioning of the company came to light in the corporate sector. Number of committees were appointed internationally to study the problems concerning malpractices and for improvement of corporate governance. Some of the internationally proclaimed committees filed reports with recommendations suggesting measures for improvement in Corporate Governance. These committees also considered the constitution of the audit committee in order to promote financial accountability and transparency. Cadbury committee on Financial Aspects of Corporate Governance set up in the UK in 1991 also stressed the need for audit committees. The same was reiterated by the Greenbury committee and the Hampel committee appointed in 1993 and 1995 in the UK respectively[97]. In India an association of industries called CII also stressed on the need of audit committees to be set up by

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[96] Brenda S. Birkett, *The Recent History of Corporate Audit Committees*, 13, Account. Hist. J, (June 30, 2020, 11:00 PM) http://www.accountingin.com/accounting-historians-journal/volume-13-number-2/the-recent-history-of-corporate-audit-committees/#:~text=The%20New%20York%20Stock%20Exchange,audit%.

[97] Neeta Shah and Christopher J. Napier, *the Cadbury report 1992: shared vision and beyond*, DATAUNBIG (July 6, 2020 6:00 PM) www.data.unbig.it.

corporations in India[98] . Thereafter SEBI constituted Kumar Mangalam Birla committee in 1999.

The Kumar Mangalam Birla committee made recommendations about the audit committee in its report. The committee mentioned in its report that the audit committee is a vital tool for corporate governance that endorses accountability and credibility in financial reporting which in turn promotes investors confidence. The audit committee is an instrument to oversee the financial reporting system. Kumar Mangalam Birla committee made recommendations regarding the composition and independence of members of audit committee. The Birla committee also recommended that the audit committee should meet at least thrice year for reviewing the financial accounts of the company[99].

SEBI directed the stock exchanges to insert a new clause to the listing agreement and adopt the recommendations of Birla committee. It is a circulation that will be followed by the listed companies. The new clause 49[100] inserted in the listing agreement included regulations on setting up of the audit committee. After the insertion of clause 49 by SEBI there were changes made in the law regulating companies' in 1956[101]. An amendment in 2000[102] introduced section 292A enacting audit committee in the Companies act also. This Section made it mandatory for entities of public nature with equity capital amounting to five crore or higher to constitute an audit committee. Section 292A empowered the audit committee by making its recommendation binding on the board. The above mentioned section also imposes the duty on the audit committee by making it compulsory for the committee to meet the auditors and discuss the compliance of internal control system and observe financial system of the company[103].

In the year 2001 Enron filed for bankruptcy shocking the Wall Street of America by the biggest auditing scam in the history of America. One of the leading giants in the US

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[98] *CII task force report on Corporate Governance*, India Infoline News Service, Dec1,2009, (June 30,2020, 5:00 PM) https://www.indiainfoline.com/article/news-top-story/cii-task-force-report-on-corporate-governance-113092902056_1.html

[99] *Key recommendations of Kumar Mangalam Birla committee report*, Gktoday, (July 8,2020, 3:20 PM) https://www.gktoday.in/gk/key-recommendations-of-kumar-mangalam-birla-committee.

[100] Securities and Exchange Board of India (SEBI), Clause 49 Regulations, Circular No. SEBI/CFD/DIL/CG/1/2004/12/10 October 29, 2004. ((July 8,2020, 3:20 PM) http://www.sebi.gov.

[101] The Companies Act, 1956

[102] The Companies (Amendment) Act, 2000, No. 53, Acts of Parliament, 2000 [13th December, 2000.]

[103] Section 292 A, The Companies Act, 1956

crashed to the ground and declared bankrupt. This scam was so huge that it led to a lot of litigation in the US. Within a year of the Enron debacle the Sarbanes-Oxley Act of 2002 came into force. This legislation brought changes in regulations governing auditor independence and audit committees in order to protect the interest of investors from fraudulent accounting practices of a corporation[104].

This legislation was enacted by the legislators in USA following Enron debacle. India tried to bring its auditing standards in consonance with the international standards of accounting and corporate governance. SEBI constituted the Naresh Chandra committee; it filed its report in 2002. The report details around the entire range of statutory auditor and company relationships. The report tries to suggest ways for improving the independence of the auditing sector of a corporation. The report examines issues such as rotation of audit firms versus that of auditing partners, appointment and remuneration of auditors, determination of audit fees, restrictions on non audit work and related subjects. This report focuses on matters involving the authority responsible for keeping a check on performance of auditors and examining the current system of regulation. This committee has also analysed the need for setting up an independent regulatory body to oversee the quality of audit of public limited companies[105]. This measure has been borrowed from the SOX Act in the USA under which a public company accounting oversight board had been prescribed[106]. SEBI had setup N. R. Narayan Murthy committee on corporate governance. The committee submitted its report in 2003[107]. This committee was constituted to review governance issues and clause 49 thereafter suggested measures for improvement of corporate governance. This committee also gave importance to audit committees and focused on responsibilities of the audit committee, quality of financial disclosure and requiring boards to assess and disclose business risk in the company's annual report. The committee recommended only non executive directors to be the member of audit committee, stressed on audit reports and auditor qualifications. This

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[104] Sarbanes-Oxley Act of 2002, (July2 2020, 11:00PM) , http://www.law.uc.edu/ccl/soact/toc.html.

[105] R.Kannan,*Indian Banking Today & Tomorrow, Report of Naresh Chandra Committee on Corporate*, OOCITIES, (July 10,2020, 9:00 PM) Governance, ,http://www.oocities.org/kstability/inbank/corpgovern/dca.html

[106] Ibid.

[107] *The report of Shri N. R. Narayan Murthy committee on corporate governance*, SEBI, (July 10, 2020 2:52 AM) https://www.sebi.gov.in/reports/reports/mar-2003/the-report-of-shri-n-r-narayana-murthy-committee-on-corporate-governance-for-public-comments-_12986.html .

report tried to lay a specific duty on the shoulders of Management in case of companies diverging from the accounting standards to rationalize the need of such alternative treatment[108]. In the year 2004 SEBI set up JJ Irani committee was constituted with a task to advise[109] Indian government on revision to the 1956 act related to companies. This has been done to simplify the complex law and to bring it in consonance with the internationally accepted practices.[110] Report of the committee was divided into seven parts and thirteen chapters that addressed different issues within the ambit of company law. The issues being addressed by the committee were regarding improvement in the governance structure of the company in order to enhance greater accountability and transparency so that there is proper disclosure of a related party transaction and minority rights are protected. Committee also addressed other shows necessary for enabling protection of small investors, changes that need to be done in the regime governing access to capital maintenance of accounts and conduct of audit of companies, ways and means of creating the process of merger and acquisitions more well organized, effective investigation and prosecution of company offences with proper emphasis on officers in default and providing a model, balanced and effectual regime for addressing corporate insolvency.[111]

The Recommendations made by various committees like Naresh Chandra Committee, JJ Irani Committee to improve the standards of corporate governance also focused on the role of auditor and audit committee as a tool to ensure transparency and accountability. Some of these recommendations were included in the Companies Act to give it authority and sanction of law. Based on this recommendation the companies bill 2008 was presented before the parliament which lapsed due to dissolution of Loksabha[112].

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[108]Piyali Sengupta, *Narayan Murthy committee: comment*, RESEARCHERS CLUB, (July 12, 2020, 3:33 PM) https://researchersclub.wordpress.com/2015/02/05/narayan-murthy-committee-comment.

[109] report on company law, (July 12, 3:45 PM) http://www.primedirectors.com/pdf/JJ%20Irani%20Report-MCA.pdf)

[110] *JJ. Irani Committee: A Comment,* RESEARCH CLUB, (July 13, 2020, 10:00 AM) https://researchersclub.wordpress.com/2015/04/21/jj-irani-committee-a-comment.

[111] Government Of India, Ministry Of Company Affairs,Press Note - 03/2005,Presentation of the Report of the Expert Committee on Company Law by Dr. J.J. Irani, Chairman of the Expert Committee,(July, 13, 2020, 4:33 PM Feb.,2019), http://www.mca.gov.in/Ministry/pdf/press_release/Press_032005.html)

[112] Standing Committee on Finance (2009-2010), Fifteenth Lok Sabha, The Companies Bill, 2009 – Twenty-First Report(Aug. 2010) (July 13, 2020, 2:00 AM) http://www.manupatra.com/manufeed/contents/PDF/634805401996915975.pdf

4.2. POST SATYAM SCENARIO

In January 2009 India was rocked by massive corporate governance scandal Satyam computers. Chairman of the company confessed to a fraud amounting to 1 billion USD[113]. This scam rocked the nation and laid the foundation for legislative and regulatory changes that help in strengthening corporate governance norms in India.

4.2.1. Introduction of companies act 2013

Companies' bill 2009 was presented before the parliament remains the same as its predecessor presented in 2008. The Companies bill 2009 was given to the standing committee of finance under chairmanship of Mr. Yashwant Sinha. Standing committee reviewed the bill and issued its report in 2010[114].The unchanged bill introduced in 2009 did not acknowledge the occurrences of the scandal that rocked the entire nation and the corporate world. Standing committee outlined the defects and recommended detailed provisions to prevent such kinds of failures in future. The recommendations made by the committee higher standards of corporate governance and measures to control company management and impose higher standards on auditors and independent directors who act as a gatekeeper to corporate governance[115]. The bill was introduced by the government as The Companies Bill 2011 before the parliament but was referred back to the standing committee to review the changes it recommended to be made in the previous version[116]. After this the Companies Act was passed in 2013 was passed by both the houses and received assent of the president of India.

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[113] Craig, Russell, et al. *Exploring Top Management Language for Signals of Possible Deception: The Words of Satyam's Chair Ramalinga Raju*, J. Bus. Ethics, vol. 113, no. 2, 2013, pp. 333–347. JSTOR,(July14, 2020, 6:00PM) www.jstor.org/stable/23433702.,4 Aug. 2020

[114] Standing Committee on Finance (2009-2010), Fifteenth Lok Sabha, The Companies Bill, 2009 – Twenty-First Report(Aug. 2010).

[115] Standing Committee on Finance (2009-2010), Fifteenth Lok Sabha, The Companies Bill, 2009 – Twenty-First Report(Aug. 2010), standing committee report summary, (July 14, 2020, 8:00 AM) https://www.prsindia.org/uploads/media/Companies%20Bill,%202009%20Standing%20Committee%20Summary%20Report.pdf

[116] Standing Committee on Finance (2011-2012), Fifteenth Lok Sabha, The Companies Bill, 2011 –Fifty-Seventh Report(Jun. 2012), (July 14, 8:15AM) https://www.prsindia.org/billtrack/the-companies-bill-2011-2122.

4.2.2. Provision in Companies Act related to audit committee:

Section 177 deals with audit committee's composition, applicability, its powers and functions. This section tries to empower the audit committee by imposing duty on the board of company listed as public entity to institute an audit committee. The section also tries to ensure the independence of the audit committee by making the majority presence of independent directors on the committee compulsory. Section also defines the powers and functions of the committee in order to eliminate possibility of conflict in future with the board. The introduction of a vigil mechanism under section 177(9) has been made to ensure that any discrepancy on financial grounds reaches directly to the chairperson of the audit committee so that direct action can be taken[117].

In order to enhance the transparency the Companies Act section 134 (3) has laid down a duty upon the board of directors to make disclosure regarding composition of audit committee in report prepared by directors. The board is also supposed to cite reasons in the report for not accepting recommendation of committee[118].

Applicability of the section

Section 177 Companies Act 2013 applies to [119] all public company with paid capital of ten crore or more; or having turnover of rupees hundred crore or higher; or having in aggregate debt exceeding rupees fifty crore or higher shall constituent an audit committee. The scope of applicability of this provision has been widened in comparison with section 292 A of the Companies Act 1956.

The listed companies that already had constituted the audit committee according to Section 292 A of 1956 Act have to reconstituted the audit committee according to the new rules laid down in section 177 (3). The time frame mentioned in the section is within one year of commencement of such rules or appointment of independent directors whichever is earlier. (i.e. on or before 31st March, 2015)[120].

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[117]Section 177(9) The Companies Act 2013

[118] Section 134(3), The Companies Act, 2013

[119] The Companies (Meetings of Board and its Powers) Rules, 2014,Published vide Notification No. G.S.R. 240 (E), dated the 31st March, 2014,act2854)

[120] section 177(3) The Companies Act ,2013

4.2.3 LODR REGULATIONS 2015

Security and exchange board of India (SEBI) on 2nd September 2015 issued LODR Regulations 2015[121]. This regulation was brought by SEBI in order to bring the basic framework governing the regime of listed companies in consonance with legislation governing companies. Section 177 governing audit committee has to be read with regulation 18 of SEBI (LODR) regulations 2015[122]. There is some point of differences between LODR regulations Companies Act 2013. According to LODR regulations audit committee shall consist of 2/3rd members as independent directors and the head of committee should be an outside director whereas section 177 states that committee should be constituted in such a way that independent directors are the majority members but the chairman need not to be an independent director. Regarding the qualifications of a chairman both the regulations differ, according to Companies Act majority members including the chairperson should be financially literate[123] whereas according to the LODR regulations all the members need to be financially literate.[124]

4.3. THE PRESENT SCENARIO

4.3.1 The companies' Amendment Act 2017[125]

The Companies Act 2013 had replaced its predecessor and brought in many changes in various provisions with it. The provision related to the audit committee is Section 177 substituted section 292 A of the previous act of 1956. Section 177 was amended by company's amendment Act 2017.[126] The amendment made in 2017 substituted the words "the listed companies" in section 177 with "the listed public companies".[127]

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[121] SEBI (LISTING OBLIGATIONS AND DISCLOUSURE REQUIREMENT)2015, vide its Notification No. SEBI/LAD-NRO/GN/2015-16/013 dated 2nd September, 2015.
[122] Rule 18,SEBI (LISTING OBLIGATIONS AND DISCLOSURE REQUIREMENT)2015.
[123] Section 177(2), The Companies Act, 2013.
[124] Supra note 122.
[125] The Companies (Amendment) Act, 2017.
[126] Companies amendment Act 2017 Highlight of Companies (July 14, 2020, 10:00 AM) Bill2017https://www.icsi.edu/media/webmodules/Highlights_CompaniesABill_2017_191217.pdf.
[127] Section 177(2) The companies Act ,2013 amended by The Companies (Amendment) act 2017.

Another committee was constituted by SEBI on June 2, 2017 under the chairmanship of Mr. Uday Kotak. The committee was formed to provide recommendations on ways to improve standards of corporate governance of listed companies in India. This committee in its report made many recommendations in order to improve corporate governance norms in India[128]. Along with many recommendations there was also recommendation made regarding the role of the audit committee. Committee was of the view that the audit committee should also review the utilization of funds holding company into its subsidiary. The role of committee comes into picture when the total amount of loan or advances or any form of investment done by the holding company into the subsidiary exceeds INR hundred crore or ten percent of the total resources owned by subsidiary, the lesser amount will be considered including existing loans or advances or investments that are existing on the date when this provision into effect.[129] This recommendation made by the committee was accepted by SEBI as a result of which an amendment was made by inserting new sub-clause (21) in schedule II, part C, clause A in SEBI LODR regulations.[130]

LODR regulations have been amended after accepting the recommendation of the kotak committee in 2018. Into the amendment audit committee played the role to review applications made by subsidiary companies for loan advances or investment made by the holding company. The amount exceeding hundred crore for 10% of the asset size of the subsidiary needs to be reviewed by the audit committee. The amount will include the existing loans or advances or investment as on the date of this provision coming into force. It was made compulsory for the company having subsidiaries to publish quarterly consolidated financial statements weather condition at least 80% of the consolidated revenue assets and profits should have been audited or reviewed. Cases any material

[128] The Kotak Committee report, (July 14, 2020, 10:15 PM) ,http://www.nfcg.in/KOTAKCOMMITTEREPORT.pdf.

[129] Medha Srivastava and Adamya Vikrant *India: Analysis Of Kotak Committee Recommendations On Corporate Governance*, MONDAQ, 03 January 2020, (July 15, 2020, 1:08 AM) https://www.mondaq.com/india/corporate-governance/875864/analysis-of-kotak-committee-recommendations-on-corporate-governance#:~:text=The%20Committee%20recommended%20that%20all,effect%20from%20April%201%2C%202022.)

[130] Clause 21, SEBI (LISTING OBLIGATIONS AND DISCLOSURE REQUIREMENT)2015.

adjustments had been made the last quarter which relate to the earlier period have to be disclosed. Cash flow statements are required to be disclosed every six months[131].

Amendments to Section 177 in the year 2018[132] were made regarding the roles and responsibilities of the audit committee. Transactions involving an amount of rupees 1 crore are avoidable at the option of the audit committee if the transaction was made without the approval of its committee and was not ratified after that. The Audit committee was able to give recommendations to the board that it did not approve the transactions that were not covered under section 188. No prior approval of the audit committee was required in case of related party transaction between holding company and wholly owned subsidiary other than those mentioned in section 188.[133]

4.3.2 NFRA (National Financial Regulatory Authority)

Amendment of 2018 brought a major change in terms of accounting and auditing authority. Section 132 of the Companies Act 2013 was amended and the body known as National regulatory financial authority was introduced under the section.This independent body established under section 132 was made to assist legislators in forming legislations related to accounting and auditing[134].

The central government has introduced companies' amendment Bill 2020[135] he Central Government had, in continuation of its efforts to facilitate greater *"ease of living to law abiding corporate"*, formed the Company Law Committee (CLC) on 18 September 2019 comprising of representatives from the "*Ministry, industry chambers, professional institutes and the legal fraternity"*. The CLC submitted its report on 14 November 2019 (CLC Report).[136] Based on the CLC Report, the Ministry of Finance has introduced the Companies Amendment Bill 2020 (Bill) which seeks to make extensive amendments in

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[131] Sandeep Shah & Amrita Bhatnagar, *SEBI revises LODR Regulations*, LAWSTREETINDIA, (July, 14, 2020 3:00 AM), http://www.lawstreetindia.com/experts/column?sid=247.
[132] The Companies (Amendment) Act, 2018.
[133] Section 188, The companies Act, 2013.
[134] Section 132, the companies act 2013.
[135] THE COMPANIES (AMENDMENT) BILL, 2020 , Bill no 188 of 2018
[136] Shubhangi Pathak , Saurajay Nanda and Ribhu Garg , *India: The Companies (Amendment) Bill 2020 – A Welcome Change To Business And Commerce,* MONDAQ, (July 5, 2020 11:00 PM), https://www.mondaq.com/india/corporate-and-company-law/928620/the-companies-amendment-bill-2020-a-welcome-change-to-business-and-commerce)

the Companies Act to make amendments in the company act 2013. The proposed bill also aims to enhance auditor independence in India. This bill will define the role of auditors and audit committee more properly in the coming future.

4.4. RESPONSIBILITY OF AUDIT COMMITTEE

Audit committee main objective is to overseas audit process within the organization and be the financial eyes of the management. Audit committee overlooks application of accounting policy and standards, financial management, internal control system, risk management business policies and practices protection of company's assets. What is the role of the audit committee to make sure those laws and regulations, of accounting are maintained by the internal as well as external auditor. The audit committee is in general responsible for the financial health of the company. The external auditors of the company also the audit reports to the committee. The Audit committee acts as a link between the auditors and Management. Facilitation of communication between the internal and the external auditors in a company. Audit committee is also responsible for the appointment, remuneration of the external auditor’s independence. Being the watchdog of corporate governance dog the chairperson of the audit committee is directly accessible to a person reporting any discrepancy in conduct management it and Finance of the company or or any fraudulent activities happening in the company.

4.5. ROLE OF STATUTORY AUDITORS

Structure of corporate governance has been developing very rapidly since the last 20 years. India, trying to keep up with the international standards of corporate governance from time to time reviewed its corporate policy. These developments in corporate governance have consolidated the auditor’s position as a watchdog[137]. Auditing failures like Enron, Satyam, and more recently PNB, IL&FS has dented the reputation of auditing profession. Good corporate governance takes care of the interest of all the stakeholders

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[137]Turnbull Shann, Corporate Watchdogs: Past, Present and Future? SSRN, (February 2002) (July, 17, 2020, 5:00 AM) https://ssrn.com/abstract=608244 or http://dx.doi.org/10.2139/ssrn.608244.

and the long term goal of the company. The auditor plays a very important role in keeping oversight on the company management and ensuring transparency.

4.6. ROLE OF AUDITORS BEFORE SATYAM

India is taking Strengthening of corporate governance norms very seriously. It is evident from various committees constituted by SEBI recommending ways to improve corporate governance in India. Kumar Mangalam Birla committee report, Irani committee report, Naresh Chandra committee report Narayan Murthy committee report suggested various recommendations to strengthen the corporate governance structure. Various challenges were faced on the way like the Satyam computers scam which led to major changes in the regulations governing audit committee auditors in India. In order to align the Companies Act corporate governance the whole Act was substituted. The Companies Act 1956 was substituted by its successor The Companies Act 2013 any recommendations of these committees implemented by the act. This act came as a major breakthrough to align corporate governance norms with Companies Act 2013. SEBI also inserted clause 49 in its regulation and later introduced the LODR regulations which together with the Companies Act tried to strengthen corporate governance. The predecessor of the Companies Act 2013 did not contain such strong provision regarding auditors which resulted in the largest scam in India. The Satyam scam was an auditor fraud, the mismanagement in the books of Satyam could not be detected by the auditor for almost 10years. The Satyam scam raised serious questions regarding the efficacy and independence of auditors. The collusion of auditors with the management questioned the professionalism of the auditor involved.[138]

4.7. ROLE OF AUDITORS IN PRESENT

Results of the scam The Companies Act 2013 was amended along with SEBI regulations which tried to empower the auditors and the audit committee to ensure transparency and

[138] Supra note 128.

fairness to instill investor confidence which would lead to strengthening of corporate governance.

For example Section 139 introduced the law relating to rotation of auditors according to which listed companies and all companies except one man company and small companies other than public company with share capital not more than 50 lakhs or turnover of not more than 2 crore is not allowed to appoint or reappoint auditor in case.[139]

- If an audit firm is appointed as an auditor then the maximum tenure it can work as an auditor is two terms of five consecutive years.
- If an individual is appointed as an auditor then the maximum tenure for such an auditor is one term of five consecutive years.

This means that one single person cannot be an auditor for more than 5 years in a company. This provision was introduced after the Satyam scam to avoid collusion of the auditors with management affecting the efficacy of auditors to detect fraud and report it.

The government in its attempt to strengthen the corporate governance norms is still amending the Companies Act 2013. SEBI constituted a Kotak committee in 2017 to recommend changes so that the standard of corporate governance can be better.[140] The Companies Act was amended 2017 and 2018 for the same purpose.

4.7.1. Role to collect information and report

Purpose of an audit is to build up the confidence of the investor in financial statements. This confidence is boasted upon by the auditor, by investigating upon the correctness and fairness of the financial statement. It is the duty of the auditor to check whether the financial statements presented are fair and true[141]. Opinion of the auditor helps the investor to determine the correct financial position of the company and make an informed choice about their investment. Auditors are given responsibilities to give effect to this transparency and fairness.

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[139] Section 139, The Companies Act, 2013.

[140] Supra note 141.

[141] Comptroller and Auditor General of India, Supreme Audit Institution of India, (July 17, 2020, 5:00 PM) https://cag.gov.in/content/financial-audit

Companies act 1956 section 227(2) was a provision which cast the duty upon the auditors to make a report[142]. This section has now been substituted by Section 143 of the Companies Act 2013 casts a duty upon the auditor to make a report about the financial statements and accounts of the company examined by the auditor. The report made by the auditor will be of the accounts and financial statements required to be laid down before the company in the annual General meeting as the companies act requires.[143]

The auditor is required to state in the report made that the accounts and financial statements give the true and fair idea of the company's financial position at the end of the financial year. In order to enhance the investor confidence the provision requires the auditor to mention in detail his views and opinion. Auditor also has to explain why the information dug up and mentioned by him/her was necessary. Also needs to explain the effect such information will have upon the financial statements of the company.[144]

4.7.2. Role to detect fraud and error

Auditors are obligated to report any fraud submitted against the company. Role of auditor as a watchdog is very important to detect fraud and nip it in the bud before it causes any material damage to the company. Auditors by applying their expertise in the field of finance exhibiting proper use of their knowledge should detect any discrepancy or fraud coming their way.

Section 143 subsection 12 clears the role of auditor in case the auditor detects any irregularities in the financial statements or has a reason to believe that fraud is being committed against the company by the officers or employees of the company. Detection of such fraud or error in the financial statements of the company should be made during the course of his duty as an auditor. Irregularity or fraud found by the auditor should be of such a nature that it affects the company materially. In case the auditor detects or believes to detect such irregularity or fraud he or she is bound to report search for to the central government within 30 days of such detection[145].

[142] Section 227, The Companies act, 1956.
[143] Section 143, The Companies Act, 1956
[144] Section 143 (2), The Companies act 2013.
[145] Section 143(12), the companies act 2013.

In the case of Sasea Finance Ltd. v KPMG it was held by the Court that where the auditor had discovered fraud being done by such an officer who is at the post where he can continue doing the same. Then, it becomes the duty of the auditor to report the condition to the company's management and not to wait till submission of their report[146].

4.7.3. Internal control and risk assessment

The auditor plays an important role in internal control and risk assessment. Auditor shall develop an understanding of the control system of the company. Some ways to develop understanding are figuring out how the management works and performs their responsibilities, identifying controls that address risks of material misstatement in the company records. Understanding the internal control and performing the risk assessment activities relevant to the preparation of financial statements has to be done by the auditor. The control system and risk assessment form integral part of accounting standards[147]. The Indian law also provides the power to auditor in Companies Act to access all the books and accounts of the company and asked the officers and employees of the company for explanations and information as he or she considers necessary for performance of his duty. This section helps the auditor to understand the internal system of control and prepare a report which has to be presented at the annual general meeting. The Auditor in his/her report has to State whether the there is effective financial control in the company and the internal control system are working efficiently or not.[148]

4.7.4. To follow accounting standards

SEBI has placed immense faith in the auditor to act as a check on corporate governance standards being followed by a company to protect the investor interest in the company by promoting transparency and fairness. Initially when it was inserted class 49 of the listing

[146] Sasea Finance Ltd. v KPMG(2002)
[147] *Identifying and Assessing the Risk of Material Misstatement*, International Standard on Auditing 315 (revised 2019), (July 19, 2020, 2:00 PM) https://www.ifac.org/system/files/publications/files/ISA-315-Full-Standard-and-Conforming-Amendments-2019-.pdf
[148] Section 143, The companies Act 2013.

agreement statutory auditors were trusted with its compliance. Companies Act also imposes a duty on the auditors to comply with auditing standards.[149]

The role of auditor has been enhanced from just reassessing the books and financial statements of the company. Development of corporate governance norms led to amendment in law or introduction of new rules and regulations like class insertion of class 49 by SEBI and further improving it by introduction of LODR Regulations. Auditors have the position of front liners and act as a defence against the fraud being committed by the companies. Corporate governance and external audit services go hand in hand. Auditors must work along with the other factors in corporate governance structure to ensure that there is transparency and the stakeholders benefit from it by receiving the highest quality of financial reports to protect their interests in a company.[150]

[149] Section 143 (9), The Companies Act, 2013

[150] Fooladi, Masood and Farhadi, Maryam, *Corporate Governance and Audit Process*, IPEDR, 20, (November 6, 2011), (July 19, 2020, 3:35 PM) SSRN: https://ssrn.com.

CHAPTER 5

LEGAL ANALYSES OF ROLE OF AUDITOR IN CORPORATE GOVERNANCE

The Indian corporate governance structure has developed from being voluntary in nature to becoming mandatory. The first institutional initiative on corporate governance was taken by the confederation of Indian Industries (CII) in 1996. A code was developed to be followed by Indian companies which were known as Desirable Corporate Governance-A code. The code was voluntary in nature, and focused primarily on transparency. The code recommended that the important information related to a company should be reported, listed companies should have audit committees, and consolidation of accounts was made optional. The code was voluntary in nature and this was one of the reasons that it was not able to change the structure of corporate governance in India.[151] SEBI was appointed to regulate financial market in India on 12th April 1988. In the year 1992 SEBI was declared an autonomous body with statutory control[152]. SEBI has been acting as agent of corporate governance and trying its best to strengthen the structure of corporate governance in India. The first initiative to strengthen corporate governance was taken by SEBI at the beginning of this century when a committee on corporate governance leaded by Shri Kumar Mangalam Birla to improve standard of corporate governance[153]. SEBI established few more committees towards corporate governance in the first decade of the century few of important ones are Naresh Chandra committee in 2002 and Narayan Murthy committee in 2002. Kumar Mangalam Birla committee came up with mandatory and non mandatory requirements.[154] Naresh Chandra committee covered the relationship between external auditor and the company they provide service to, changing external auditors or audit firm hired for services from time to time, rules for hiring auditors and rendering remuneration for their services, genuine statement of financial affairs of the

[151]Desirable corporate governance A code, NFCG, (July 20, 2020, 10:00 AM http://www.nfcg.in/UserFiles/ciicode.pdf
[152] SEBI: Role, Objective, Structure and Functions of SEBI, ELAMMARKETS, (July 20, 2020 10:45 PM) https://www.elearnmarkets.com/blog/sebi-purpose-objective-functions-sebi.
[153] Corporate governance, Circular ,SEBI Corporate governance, Circular (July 21, 2020, 7:25 PM) ,https://www.sebi.gov.in/legal/circulars/feb-2000/corporate-governance_17930.html
[154] Supra note 99.

company.[155] Narayan Murthy committee covered responsibilities of audit committee, quality of financial disclosure, requiring board to assess and disclose business risk in companies' annual reports[156]. J.J Irani committee focused the role of auditors and audit committee as a tool to ensure transparency and accountability.[157]

In order to bring the listing agreement in alignment with the Companies Act 1956 and corporate governance SEBI introduced clause 49 in the listing agreement in the year 2000.

5.1. Analysis of clause 49

Clause 49[158] was a new clause introduced in listing agreement was as an amendment to the equity listing agreement in the year 2000. Clause 49 deals with complete guidelines of corporate governance have provisions that help compliance of corporate governance. This clause contains both mandatory and non mandatory provisions. This clause imposed an obligation on a company to be transparent. This means that a company must disclose all material facts about the company to the stakeholders. This could include disclosure of financial position, performance ownership; governance etc.[159] Clause 49 had provisions which changed the role of independent directors and the audit committee in the corporate governance mosaic. The clause contained provisions related composition, role of audit committee, disclosure made to audit committee.

5.2. ROLE OF AUDIT COMMITTEE

The audit committee was a subcommittee of the board constituted to help the board of directors in oversight over financial matters and internal control system. The audit committee was responsible to look over the books and accounts, review them and report

[155] Supra note 105
[156] Supra note 107.
[157] Supra note 111.
[158] Supra note 100.
[159] Securities and Exchange Board of India (SEBI), Clause 49(1) Regulations, Circular No. SEBI/CFD/DIL/CG/1/2004/12/10 October 29, 2004, (July 22, 2020, 12:00 AM) http://www.sebi.gov.

about to the board, provide recommendation on an eligible candidate as an auditor. The role of the audit committee was not just limited to inspect the books of the company.

5.2.1 Composition of the committee

Audit committee shall be composed in a way that two third of the directors shall be independent directors and the lower limit to total number of member is three directors. To qualify as a member of the audit committee one must be financially literate and at least one of the members should have expertise in the area of finance and accounts. This committee shall be chaired by an independent director. Secretary of this committee shall be a qualified CS. A fact that maximum members the independent director increases the chances of transparency and disclosure by the audit committee. The independent directors are free from management not influenced by it. Better transparency can be expected from the independent directors[160].

5.2.2Meetings of audit committee

The clause made the provision for meetings to be conducted by the audit committee. The number of meetings prescribed by clause 49 at least four in 365 days. Maximum shall be held in every quarter i.e. interval between two meetings cannot exceed around four months. The quorum required for the meeting to be held requires presence of at least two members or one third of total members of the committee number of whichever are higher. There was a requirement of at least two independent directors to be present at the meeting.

5.2.3 Powers and duties of the audit committee

The Audit committee was given the role to oversee the financial reporting and disclosure process, performance of internal audit functions, risk management policies. The Audit committee was also responsible for all the functions of external auditor starting from

[160] Section 177 (2), The companies Act, 2013.

hiring till independence of such auditor. It was the role of the committee to help the board of directors oversees the regulatory compliance of auditing standards in the company. Since clause 49 made whistle blower policy mandatory for the company it was the responsibility of the audit committee to oversee and report the whistleblower to the board. This clause even requires all the third party transactions to be approved by the audit committee.[161]

Clause 49 empowered the audit committee and provided it with powers to investigate any activity which was in its ambit or area of expertise. The audit committee could seek information from any employee in the course of the investigation and could also call an outsider with relevant expertise to help the audit committee in conducting investigation. The audit committee was also free to seek legal advice from outside the company if the committee deemed fit to seek.[162]

Clause 49 was implemented for better transparency and accountability by the company. The inclusion of independent directors to be the majority member in the audit committee is further strengthening the transparency. The role of the audit committee to detect fraud and oversee the hiring and independence of the auditor is in a way enhancing the chances of proper depiction of financial health of a company in front of the stockholders. This clause has let the audit committee assume the role of bridge between the board and the auditors also represent shareholder interest. [163]

5.2.4. Drawback

There are some drawbacks with this regulation like the scope of clause 49 was limited to only entities that were listed on the stock exchange and that left out all the unlisted companies from the mandatory provisions to be complied with like the existence and composition of audit committee. There were too many regulations and that created confusion in the market. SEBI was formed as an authority to regulate market and supervise listed companies, the companies act regulated all companies, banks were governed by the RBI guidelines and act, and Insurance companies were regulated by

[161] Section 177 (4), The companies Act, 2013
[162] Supra note 100.
[163] Ibid.

IRDA. There was no uniformity in applicability making it very complex to understand. The clause was very lenient in its approach toward compliance. All the listed companies were mandated to file a four monthly compliance report under this clause to the stock exchange where they were listed. Then the stock exchanges would file an annual report before SEBI. The problem with this system is that stock exchanges questioned listed entities only on non compliance. The entities took advantage of this loophole and tried to show compliance and stock exchanges with no option. On the other hand SEBI had the option to delist such companies or impose a penalty upon them. SEBI has no power to initiate criminal proceedings against such companies.[164] Clause 49 was formulated so that together with Companies Act 1956 it will ensure transparency and strengthen corporate governance. The 1956 Act was replaced by Companies Act 2013 after a government accepted recommendations from various committees. The Companies Act 2013 had provisions that governed all the listed and unlisted companies in India. Clause 49 had mandatory and non-mandatory requirements to be followed by the listed entities but it still was not in a position to be called a regulation having higher standards of corporate governance. When the Companies Act 2013 came which had various provisions like independent directors, composition of various board committees including the audit committee, sections related to appointment, rights and duties of auditors etc to ensure transparency.[165]

5.2.5 Objective of the section

An audit committee is a key element for corporate governance. It is an operating committee that acts as a bridge between the directors of the company and the auditors. The Audit committee can be called the eyes of the directors as the committee helps the board of directors to oversee financial reporting and disclosure. It is constituted with directors as its members; it is also responsible for reviewing companies' business

[164]Vikas Verma, *Clause 49 has finally found its claws*, LIVEMINT, (July, 22, 2020, 11:00 AM) https://www.livemint.com/Specials/q8fzk1qnMmgVe8cMSZ1PUI/Clause-49-has-finally-found-its-claws.html

[165]Corporate governance: clause 49 and Companies Act 2013 provisions, GKTODAY (July 22, 12:00 PM) https://www.gktoday.in/gk/corporate-governance-clause-49-and-companies-act-2013-provisions/#:~:text=Auditors%20are%20required%20to%20report,receiving%20stock%20options%20or%20remuneration.

activities and identifying any discrepancies in the financial statement of the company. The Audit committee is also responsible for the auditors and matters related to them like hiring, resolving disputes and disclosing the auditor's reports. The audit committee acts as a road which leads to disclosure and transparency.[166]

Section 177 of the Companies Act lays down provisions for the audit committee. This provision talks about the manner in which the company is constituted, it also lists down the role and function the committee needs to perform. The section is very detailed and provides for improving the effectiveness and efficiency of the company. This section is very important as it lays down the functioning of a committee which assesses the financial position of the company. A very important change has been brought about by this section, it made the whistle blower policy mandatory in India.[167]

5.2.6. Applicability of audit committee

Section 177 read with SEBI (LODR) regulations which lay down rules[168] that deal with this committee. This section needs to be analysed to understand the composition, applicability and responsibility of the audit committee.

5.2.7. Constitution of the committee

Section 177 read with rules[169] Mentions a class of companies that compulsorily require constituting an audit committee. The class of Companies having mandatory obligation to form this committee are every companies that are listed entities and every other company that is public in nature. The public company for which the constitution of audit committee is compulsory is divided on the basis of total amount paid by shareholders at

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[166] ACS Tripti Chugh, *Audit committee A keystone to corporate governance for the company's*, TAXGURU (July 22, 1:00 PM), https://taxguru.in/company-law/audit-committee-a-keystone-to-corporate-governance.html.
[167] Ibid.
[168] 6 and 7 of the companies (meetings of board and its power) rules 2014.
[169] rule 6(14), companies(meetings of board and its power) Rules 2014.

initial issuing of shares[170] and total revenue[171].The companies of public nature for whom the provision is mandatory are:

- Having capital paid by shareholders initially equal to ten crore or more than it.
- All company of public nature having total revenue of 100 crore or more.
- The companies that are public and have debt that is equal to 50 crore or more than it.

5.2.8. Composition of the committee

The Audit committee shall have directors as its members in such a way that the majority should be of independent directors. Minimum number of members required to institute the committee are three. It also has a provision that requires all the directors to be eligible to read and understand financial statements[172].

5.2.9. Meetings of the committee

Audit committee is required to officially meet every quarter in a year. All the members of the audit committee along with the auditors and key managerial personnel shall attend the meeting. Auditors and key managerial personnel do not have any voting right regarding the auditors reports that are discussed in the meeting. The provision also makes it mandatory for the head of this committee to be present at the meeting held by the committee. The quorum required for meeting to be convened at least one third of total members of the committee or at least two members whichever is lower.

To ensure the constitution of the committee the companies act has laid down a provision which lays a upon members of the board shall in its report shall make a disclosure about composition of committee and mention the recommendations by the committee not accepted by members at board stating rationale behind not accepting the same[173].

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[170] Section 2(64) , the companies act, 2013.
[171] Section 2(91) The companies act, 2013.
[172] Section 177(2), The Companies Act, 2013.
[173] Section 134(3), The Companies act 2013.

5.2.10. Role of the audit committee

Section 177 has made the role of committee more specific which also includes keeping an eye on the auditors of the company and making recommendations for appointment and remuneration given to the auditors. It can be said that the audit committee monitors the performance and independence of the auditor. Some other rules and Audit committee performs are it examines the financial statement and auditor reports. The omnibus approval for related party transactions by the audit committee after adhering to conditions as prescribed[174]. Audit committee's role is to monitor the health of the company financially which also involves scrutinizing borrowings and other money transactions, valuation of undertaking and resources owned by the company, evaluating internal financial control and risk management system.

5.2.11. Vigil mechanism

Clause 49 of SEBI agreement had brought this provision as non-mandatory. The Companies Act 2013 under section 177(9)[175] laid down provision for vigil mechanism read with regulation 18 of SEBI listing obligation regulation 2015. This vigil mechanism called whistle blower policy has to be adopted by all the companies to whom the applicability of section 177 extends to. It is a mechanism where the employees of the company can report about any kind of discrepancy in conduct of business, compromises made with accounting methods, actually speculated frauds, unethical behavior which would have hampered the position of the company. The report is directly to be made to the chairperson of the audit committee. This policy basically is ensuring transparency in company and the whistle blower i.e. the person reporting the wrong has to be safeguarded against victimization. The disclosure of such an establishment has to be given by the company on its website.[176]

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[174] Rule 6 A (companies meeting boards and its powers) rules, 2014.
[175] Section 177(9), the companies act, 2013.
[176]Bhumesh Verma and Abhishish Vidyarthi, *Whistleblowing in India: The way forward*, (July 15, 2020, 11:00 PM) https://www.scconline.com/blog/post/tag/clause-49-of-listing-agreement/.

5.2.12 Related party transactions

The Audit committee is supposed to provide omnibus approval to the transactions being done with the related parties[177]. The related parties have been defined under companies act as parties which are relatives of directors or director themselves there, KMP or their relative, a company where the manager or director or their kith and kin is a partner, a privately owned corporation where the director or manager is a member in such corporation.[178] The Omnibus approval is valid for one financial year after expiry of which the approval needs to be taken again. Audit committee after the confirming it with board shall form rules for making Omni bus proposal which involves parameters like maximum value of the transaction allowed by Omnibus route, maximum value which could be granted per transaction, degree and way of disclosure made to the committee and transactions which are barred for taking this yearly approval.[179] Audit committee also has to satisfy about repetitiveness of the transaction and the approval should only be granted by the committee when it thinks that such a transaction is for the benefit of the company.

Penalty in case of non compliance

Section 178 (8) is a substantive provision which decides the punishment for contravention of section 177 by the companies. In case of non compliance of section 177 by a corporation, it will be reprimanded with pecuniary penalty or would be sentenced to prison and every officer responsible for the default will be punishable with imprisonment or fine or with both. [180]There are no excuses for not constituting an audit committee being a mandatory provision it is necessary to be followed otherwise it results in contravention as these cases below:

- M/s Sand Land Real Estates Private Limited case: It was an application for compounding, made by a company who was in violation of section 177 companies' act 2013. The company was late by 337 days in the constitution of the audit committee as per the provision of section 177. The company contended that it was in delay in appointing independent directors as per section 149, due to huge

[177] Rule 6A companies meeting of board and its powers) rules 2014.
[178] Section 2 (76), The Companies Act, 2013
[179] Rule 15 companies (meeting of board and its powers) rules 2014.
[180] Section 178(8), The Companies Act, 2013.

outstanding loan, and hence they incurred delay in constitution of audit committee. The informed the ROC and thus should not be held liable as they did not have any mala fide intention. They were held to be liable by the court and were charged compounding fees to defer them from repeating the default. This case shows how important it is to comply with the conditions of section 177[181].

- Shruti Power Projects Private Ltd. & Ors: In this case, the company has filed an application for compounding the violation of section 177(1). It is a public company which did not require an audit committee under the act, 1956 but after the act 2013, and rule 6 of Companies (Meetings of boards and its Powers) Rules, 2014, it had to constitute the committee within a year of commencement of rules. The company did not do so and was in violation. They later formed the committee and filed this application. What is interesting is to note that the court in this case clearly held that the violation could be compounded only against the company and not against the officers in default. Both are to be punished under section 178. This again outlines the serious nature of conditions of section 177.[182]

Amendments

Section 177 of 2013 act had replaced section 292 A of the Companies Act 1956. There were amendments made to section 177 from time to time to increase its scope, applicability and stringency.

The insertion of rule 6 Companies (Meetings of Boards and Its Powers) Rules, 2014, MCA vide a notification dated 12/06/2014provided for mandatory formation of audit committee but it was not needed by the companies under the Companies Act 1956 after this amendment it is was made compulsory for all the companies to whom section 177 applies for constituting an audit committee. Time frame given to the committee is after this notification was within one year from commencement it of this rule or from appointment of independent directors whichever is earlier.[183]

[181] M/s Sand Land Real Estates Private Limited, 2017, 58/441/NCLT/MB/MAH.
[182] In Re: Shruti Power Projects Private Limited, (2017)143CL145
[183] 6 Companies (Meetings of Boards and Its Powers) Rules, 2014, MCA vide a notification dated 12/06/2014

Then in the year 2015 an amendment was made for related party transactions. The amendment had given power to the audit committee for yearly confirmation when seeked by a company for related party transactions. This amendment was made because there were a lot of obstacles for getting approval for conducting related party transactions.[184]

There was also an exception made in the year 2015, it gave exemption to section 8 companies and an amendment was made to exempt section 8 companies from having independent directors as majority in the audit committee constituted by them. This advantage will be available to those companies under section 8 who would not have committed default in filing statements and returns.[185]

In the year 2017 there were changes made in scope of applicability of the section by changing the words listed company by the words every public listed company in section 177 (1).[186]

The Audit committee is a very integral part of any company; it oversees the finances of the company which ultimately help the company to exist and survive the competition. Audit committee is said to be the backbone of a company. After analyzing the provisions related to the audit committee it could be observed that it changed from what it used to be under section 292 A of Companies Act 1956. The inclusion of independent directors as majority members of the committee boosted the independence of the committee but being a subcommittee to board the audit committee only enjoys limited independence. The members of the audit committee can just recommend and not approve the auditors to be appointed for the company so the decision lies with the board of directors. Recommendations made by this committee in the Annual general meeting also can be accepted or rejected by the board and disclosed accordingly. Audit committee shares a direct relationship with the auditor but the provision does not imply any obligation on the audit committee to ask for input from auditors the committee may do so if it desires. This could lead to leniency by the audit committee. Although the audit committee has also been given some powers under section 177 the audit committee has power to go through the books and accounts of the company and also question employees in case of any discrepancies found in the financial statements or the committee has reason for believing

[184] Inserted by Companies (Amendment) Act, 2015 and is effective from 14th December, 2015.
[185] Ibid.
[186] Companies (Amendment) Act,2017, Effective from 7th May 2018

that a fraud has been committed against the company. Audit committee giving approval for related party transactions and making of vigil mechanism mandatory under this section with whistleblowers reporting any discrepancy directly to the head of audit committee is proof enough that the audit committee is a tool to ensure transparency in a company. By analyzing the provision it can be said that the audit committee has been constituted to review the procedures and ensure efficacy of internal control procedures and accuracy of reporting. Companies Act 2013 has made the provisions more strict and officers' in default liable ensuring transparency by making punishment as a deterrent.

5.3 AUDITORS POSITION UNDER COMPANY LAW

The investors providing capital to a company and investing in it from time to time would want to know the financial position and status of the company and whether their investment is safe or not. To present or true and fair financial account of the company the auditors are appointed by the company. Details of the person who inspect and review the accounts of the company but are not employed in the company or complicated towards the company in any way so that a true and impartial picture of the monetary situation is presented to investors whose confidence of is instilled in the company. Audit is an examination for scrutinizing the accounts and statements of a company to ascertain accuracy of financial statements provided by the company to detect any errors are fraud in the books of the company[187].

5.3.1 Appointment of an auditor

The first auditor of the company is appointed by resolution or board of directors or in a General meeting. Such auditor shall be appointed within thirty days from the date of registration of the company. The first auditor has to hold his office till annual general meeting takes place. If board fails to appoint auditors its duty is shifted to the members of the company to select the first auditors in an extraordinary general meeting within 90

[187] *Definition of audit*, ET, (July, 12,2020, 1:PM) https://economictimes.indiatimes.com/definition/audit

days of registration.[188] The case of government is different, when a company is completely owned by the central government or in partnership with government of a state the first auditors need to be appointed by the 'Comptroller and Auditor General of India' within a period of sixty days from the date of registration of a company. In case the comptroller and auditor general fail to appoint such auditor the board is entrusted with the duty to appoint such auditor within 90 days. In case the board fails the members shall appoint such auditor within 60 days in extraordinary meeting.[189]

5.3.2. Subsequent auditors

It is mandatory to appoint subsequent auditor after expiration of term of first officer. The board is required to appoint an auditor who can be a single person or an auditing firm concludes an individual or a firm as its auditor at the first AGM. The tenure of subsequent auditor appointed would be for a term of five years[190] the need for ratification of such appointment at every Annual general meeting has been done away with in 2018 to reduce the complexity of the procedure. Audit committee is supposed to give recommendations for appointment[191] of the auditors procedure has been laid down in companies' rules 2014[192].

The subsequent auditor is appointed cannot be reappointed after serving for a continuous period of five years for more than one term of five consecutive years if the auditor appointed is an individual and in case the auditor appointed as form the reappointment it cannot be done if it has enjoyed a 2 terms of 5 consecutive years. The appointment is subject to five year cooling period which means that an auditor can be reappointed after 5 years of completing its term of consecutive 5 years in case of individual and consecutive 10 years in case of a firm as an auditor. The auditor needs to rotate after completion of these 5 or 10 years depending on the fact that appointed auditor is a firm or individual. For calculating the period for which a firm or individual holds the office will also take

[188] Section 139(6), The Companies Act, 2013
[189] Section 139(7), The companies Act, 2013.
[190] Section 139(1), The Companies Act, 2013.
[191] Section 139 (11), The Companies Act, 2013.
[192] Companies (Audit and auditors)rules 2014.

into account the period of service of an auditor at that particular company before the commencement of the act. [193]

The mandatory provision for rotation of auditors to be followed by all the entities listed, unlisted public company having capital from the first issuance of share amounting to rupees ten crore or more, companies of private nature having capital from the first issuance of share amounting to rupees twenty crore or more. This provision also applies to companies that have debt amounting to rupees fifty crore or more but share capital is less than ten for an unlisted entity of public nature and twenty crore for an entity of private nature.[194]

5.3.3 Filling of casual vacancy

If a situation arises whereby there is a casual vacancy, the Board of Directors is mandated to fill the same within 30 days. However, this is subject to the limitation that where the vacancy has arisen due to resignation, it can be filled only by company after convening a meeting within a period of three months from the date of recommendations given by the. If unusual vacancy arises in company owned by government either completely or partially, it shall be filed by the C&AG of India in a period of thirty days. In case C&AG fail to appoint within such time period then BOD will fill the vacancy within next 30days. Casual Vacancy in case of other companies shall be filled by BOD within 30 days. However if this situation arises due to willingly withdrawing from position of an auditor then such vacancy has to be approved by the company after holding a meeting within time frame of three months, this period will be calculated from the day board gave recommendations. It means in case of casual vacancy through resignation also can be files by the BOD but the approval of the shareholders are required in that case. The person so appointed for filling the casual vacancy in both the cases is directed by law to remain in charge of the position as an auditor till the board and members meet for an AGM. In case of the company where the auditor is appointed by C&AG, the new

[193] Section 139(2), The Companies Act, 2013.
[194] Ibid.

appointment would be done by C&AG in a period of thirty. In case the casual vacancy is not filled by the C&AG then the BOD will fill the vacancy within next 30 days.[195]

5.3.4 Qualifications of auditor

In order to increase the efficacy and professionalism The Companies act provides for some qualifications that a person needs to possess some qualifications to be an auditor. This auditor is called a statutory auditor because it arrives with duties powers and authority from the companies act.

Section 141 provides for a Person to become auditor it is compulsory that he is a charted accountant by profession[196]. This Section also provides that a firm can also qualify to be an auditor if it is a limited liability partnership whose majority of partners practice in India.[197] the section for the provides that if a firm is hired to be an auditor in a corporation, the person should have certification under law to practice in order to give his signature in lieu of the firm[198].

5.3.5 Disqualification of an auditor

The Companies Act also provides for disqualifications possessing which a person can be disqualified from being an auditor for a corporation. This provision enhances the independence and efficacy of an auditor to conduct an audit and ensure that financial health of the company is disclosed with full professionalism. Disqualifications mentioned in the under section 141 are:

- All corporate organization are disqualified to be an auditor other than a LLP registered under law[199];
- Any person found guilty for fraudulent practices by a court of law. This disability is not of permanent nature, the minimum period to return to practice as an auditor is ten years from the date of sentence;

[195] Section 139(8), the companies Act, 2013.
[196] Section 2(17) of chartered accountants act 1949.
[197] Section 141, The Companies Act, 2013
[198] Section 141(2), The Companies Act, 2013.
[199] Limited Liability Partnership Act, 2008, No.6, Acts of Parliament, 2009.

- A person directly or indirectly rendering services mentioned in section 144 to the corporation one holds auditor's position in or any of its subsidiary or holding.[200]

Where the Chartered Accountant is employed whole-time, he is an employee of the company. In Dharangadhara Chemical Works v. State of Saurashtra [201]the court held that a Chartered Accountant who is fully employed as a Charted Accountant in a corporation cannot be hired as its auditor.

5.3.6 Resignation and removal of auditors

The auditor can resign on their own accord or can be removed if found guilty of either doing fraudulent activities or collude with the management to do fraudulent activities.

5.3.6.1. Removal of auditor

Company law lays down provisions with respect to the removal and resignation of an Auditor. As per provision 140(5) if an Auditor has been found guilty for direct involvement or aiding a company in a wrong way or if an Auditor is liable for helping or being a part of any activity that is fraud, then the NCLT can, take cognizance of the matter either on their own or after receiving complaint from any aggrieved person or person related to the company, or Indian government, order such a company to replace the auditor. When a complaint with respect to removal of an Auditor on the grounds of fraud has been made by Indian Government to NCLT thereafter, if NCLT is convinced that such Auditor has acted in a fraudulent way, then NCLT can, in a period of fifteen days of receiving such a complaint, issue an order to remove the Auditor and a new auditor can be hired by the government replacing the old auditor.[202] The removed Auditor is barred from continuing his or services as an auditor for a period of five years and will also be tried under Companies Act.[203]

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[200] Section 141, The companies Act, 2013.
[201]Dharangadhara Chemical Works v. State of Saurashtra, 1957 AIR SC 264.
[202] Section 140(5), The Companies Act, 2013.
[203] Section 447, The Companies Act, 2013.

Time of fifteen days is given to NCLT to investigate the charges against the auditor and conclude whether an Auditor has acted in a fraudulent manner or not. One is not sure if such a time period is sufficient for concluding a detailed enquiry in complex matters. It has been clarified that an Auditor for the purpose of section 140 (5) includes a firm of Auditors. Further, in case the conduct of a firm is called into question under section 140 (5), then the firm and every partner of the firm involved in fraud activities is liable. Partners or the firm involved in fraud in any way will alone face the criminal charges and not the entire audit firm.[204]

Constitutional validity of section 140(5) has been held up by the high court which seeks removal of existing auditors, but said that it would not apply to auditors who have resigned. In October 2019, Deloitte Haskins and Sells had moved the high court challenging the constitutional validity of Section 140 (5) of the Companies Act, to remove auditors, and the Ministry of Corporate Affairs (MCA) plea at NCLT seeking a ban on auditors for five years.[205]

5.3.6.2. Resignation by auditor

Section 141 has a provision for resignation of auditors if an auditor wants to resign willingly from his post then the concerned person has to inform the registrar of the companies in a prescribed form and manner. There is a time frame provided by the section within which the auditor has to inform the register of Companies. The information regarding the resignation has to be intimated within 30 days from the day of resignation.[206]

In case the companies a government company auditor shall file resignation before Comptroller and Auditor General of India[207]

SEBI had issued a circular on 18th October 2019 relating to resignation of auditors from listed companies and their subsidiaries. SEBI issued a circular for compliance by the companies in order to provide timely information about the resignation of the auditors to

[204] Supra Note 201.
[205] Supra note 202.
[206] Section 140(2), The Companies Act, 2013
[207] Section 139(5), The Companies Act, 2013

the investors so that they make an informed decision about their investment. Major amendment following the circular was that the listed companies have to inform the stock exchange 24 hours of receiving the reasons from the auditor for resignation. [208]

5.3.7. Rights of an Auditor

The Companies Act, 2013 has provided a wide array of rights to the auditor to ensure that he is able to discharge his duties effectively. The rights of an auditor are his statutory rights and cannot be limited or abridged either by the Articles or resolution of the members.

1. Right of access to books and account:

The auditor of a corporation will have access to books of record, financial accounts and vouchers of the company[209]. The term 'vouchers' includes all documents, correspondence, agreements, etc., which support any of the transactions or data disclosed in the financial statements, directly or indirectly. The term books include the fiscal and statistical books. The phrase 'all times', however, implies only to the normal business hours. In the auditor is appointed by holding company he or she will have right to access the abovementioned records of the subsidiary and associate of such a corporation to relate the financial statements with the statements of subsidiary and associate.[210]

2. Right to obtain Information or Explanation:

The auditor of a company has the right to inquire and seek explanations' from the officers employed at a company. The information extracted by auditor will be such that he/she thinks important in order to discharge their services as auditor.[211] The auditor can especially inquire matters that can detrimental to the interest of the company and its members and could affect the financial health of the company adversely like a loan

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[208]SEBI Circular No.: CIR/CFD/CMD1/114/2019,(July 30, 2020, 3:38 PM) https://www.sebi.gov.in/legal/circulars/oct-2019/resignation-of-statutory-auditors-from-listed-entities-and-their-material-subsidiaries_44703.html.

[209] Section 143(1), The Companies Act, 2013.

[210] Proviso Section 143(1), The Companies Act, 2013.

[211] Supra note 208.

without collateral will lead to company spending from their pockets as it happened in the PNB scam case.

3. Rights with respect to Branch Accounts:

A 'branch office[212]'of a company means any office described by the company as one. This office also requires audit as it is a part of the corporation. Audit of the branch office can be done by the auditor auditing the accounts of company this office is a part of, or another qualified auditor can be hired to offer services for this office[213]. If this abovementioned office is somewhere outside Indian boundaries then its account can be audited by company's auditor or a new one can be hired to do the same. The point here is application of law to such office would of the country where such office is situated and not Indian law. When a new auditor is appointed to audit branch office account, the company law imposes a duty upon the branch auditor to submit a report to the auditor of the concerned company of which branch office is a part of.[214]

4. Right to sign the report:

Every auditor has right to sign the audit report or certify documents of a company they are hired by, the requirement of possessing the professional qualifications' of charted accountancy are required for those auditors who are partner in a LLP. Only those partners of LLP are authorizes to sign or certify a document or report who are CA's**.**

5. Right to receive notices:

Auditors appointed by a corporation have right to receive notices or any information relating to the intimation of a general meeting taking place and the same should be sent to auditors.[215]

6. Right to Attend General Meeting:

The auditors have right to attend every AGM held while they are in service at a company and not just to be a mute spectator but also give suggestions and opinions as they have a right to be heard at meetings and at any point which involves them as auditor's.**[216].** Auditor is free to make statements concerning the financial statements. It is not obligatory on the auditor to attend the meetings or AGM personally, they are free to send

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[212] Section 2(17), The companies act, 2013
[213] Section 143(8), The companies Act, 2013
[214] Rule 12 Companies (Audit and accounts), Rule 2014.
[215] Section 146, The Companies act, 2013
[216] Ibid.

someone representing them in their place. It is mandated by law to read out the report submitted by the auditor having comments or observations regarding financial transactions' at the AGM and is open to be checked by any member of company.[217]

7. Right to receive Remuneration:

An auditor is entitled to his remuneration on the completion of his work.

5.3.7 Duties of an Auditor

Every right available to an individual has a corresponding duty. An auditor under the Companies Act is no exception. They have a general duty to oversee that the company's financial statements are in order and present a true picture of the state of affairs of the company. Apart from this, the Act also prescribes certain mandatory duties within its domain.

1. Duty to make a Report of Financial Transactions:

The auditors are hired to provide their expertise to detect any discrepancy in the financial transactions of a company. It becomes the duty of an auditor to present a report before members of the company at AGM about all the investigations and examinations conducted by him/her of the accounts and books of the company.[218] [219]The auditor is duty bound to report at the financial year end a genuine picture of the financial position of a company investing professional skills. The auditor has to answer all the questions related to books kept by company, P&L Accounts reported etc.

2. Duty to Attend General Meeting:

It is the duty of appointed auditor to attend AGM held by the company and if due to some reason he/she is unable to do so can send an authorized person who is qualified to be an auditor to attend the same. The auditors can skip the meeting when they are exempted by the company[220].

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[217] Supra Note 214.

[218] Section 143 (2), The Companies Act, 2013.

[219] Section 143 (5), The Companies Act, 2013.

[220] Section 140, The Companies Act, 2013.

3. Duty to Report Fraud:

It is the duty of auditor to report fraud that his happening in his/her course of employment or have a strong reason to justify their suspicion about fraud taking place against company by the officers and employees. The auditor will report this fraud to Indian Government if the amount of fraud exceeds rupees one crore.[221] The auditor first needs to forward his report immediately (not later than two days) to the audit committee or the Board. Auditor receives a reply of board or committee in a time period of forty five days. After receiving the reply auditor has to send the report, comments and reply formed by him/her to Indian government in time frame of fifteen days[222].

Conclusion:

Auditor's role has increasingly gained an important stature in corporate governance. In the age of increasing numbers of frauds, an auditor keeps an eagle's view on accounts, finance of the company to ensure that the company is working in the best possible manner. However, this can be ensured through an independent and autonomous body which is not regulated by the company's managerial positions. The establishment of NFRA was a measure to enhance auditor independence.

5.4 NATIONAL FINANCIAL REPORTING AUTHORITY (NFRA)

Five years after the Companies Act, 2013, MCA 01st October, 2018 constituted National Financial Reporting Authority ("NFRA") to establish an independent regulator for strengthening the audit profession and regulating auditors, to comply with standards of accounting and auditing so that the quality of auditing is enhanced relating to accounting and auditing standards. Further, by notification dated 24th October 2018, the Ministry notified the remaining subsections of Section 132 of the Act[223].

[221] Section 143(12), The Companies Act.
[222] Ibid.
[223] Section 132, The Companies Act.

Subsequently, the National Financial Reporting Authority Rules, 2018 **("NFRA Rules")** notified by the Ministry on 13th November 2018, w.e.f. 13th November 2018. The NFRA rules deal with the jurisdiction (scope), function, duties and powers of the NFRA[224].

5.4.1 Now NFRA is a reality

NFRA became a reality in 2018 and now is responsible for making recommendations to Indian government in relation to policy development for accounting and auditing standards in India. This authority will also suggest level of standards to be adopted by companies and auditors. This regulatory body will look after concurrence with set standards of audit and accounts and law relating to them. It will also oversee that the quality of service by professionals in maintained[225].

5.4.2. Constitution & chairperson of the NFRA

The cabinet approval created one post of Chairperson and three posts of Full Time Members and one Secretary for NFRA.

The constitution of National Financial Reporting Authority will be in such a way that it will be headed by a person who will be an expert in the field of either auditing or finance or law and will be selected by the Indian government. The other members appointed will not be more than fifteen people in totality including the part timers and whole timers'. The number of part timers and full timers would be according to prescription by government. All the members are required to make a declaration to the government that the appointment was done by following full procedure and is correct and fair, will not cause any conflict of interest in future. The rules bar the full time members and chairperson to be involved with any other auditing firm while being in service to NFRA in order to avoid any collusion and biases by the authority.[226]

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[224] *Understanding The Applicability of NFRA Rule*, TAXGURU, (July, 25, 2020, 11: AM) https://taxguru.in/company-law/understanding-applicability-nfra-rules.html

[225] Section 132 (2), The companies Act, 2013.

[226] Section 132(3), The companies Act, 2013.

5.4.3 Powers of the NFRA

The national financial reporting authority has power to investigate the matters related to professional or ethical or any other misconduct done by any auditor either individual or a firm or any member of a firm consisting of CA's enrolled under an act[227].This investigation conducted can be on the basis of cognizance taken by the national financial reporting authority itself or by complaint made by Indian government.

When NFRA has initiated proceedings in matter of misconduct then no other body has the right to investigate the same matter of misconduct. The powers vested in NFRA during investigation would be same as the powers of a civil court.[228]

5.4.4. Punishments & Penalties

After the investigation if an auditor or CA or firm is found guilty of misconduct NFRA has authority to punish such an offender by making an order to impose a fine of rupees one lakh the minimum. The fine imposed can be as grave as five times off the fees received if the offender is an individual person. In case of offender is a firm minimum fine increase to ten lakh and can go up to ten times of the fee received while discharging professional services. It also has power to bar guilty processional for a period of six months to ten years. Facing this sentence will stop this professional from practicing.[229].

National financial reporting authority is an autonomous and independent body regulating the auditors in India since October 2018. The authority was set up with an objective to have an institution oversight over the auditors in India and enhanced transparency and auditor independence for effective audit reporting. Indian Institute of Chartered Accountants was responsible for regulating the auditors before National financial reporting authority came into existence. The role of IICA in regulating auditors has been side lined and they have been objective in the formation of this authority fearing their

[227] The Chartered Accountants Act, 1949, No.38, Acts of Parliament, 1949.
[228] Section 132 (4), The Companies Act, 2013
[229] Ibid.

powers to be reduced substantially after the national financial regulatory authority was set up[230].

5.5. Company (Auditors Report) order 2020 (CARO 2020)

Before March 2020, The Company (auditor's report) order 2016[231], governed the auditor's report of financial statements of the company. The notification of CARO 2020 has now brought the format of auditor's report in its ambit. The new order of 2020 has brought about many changes. These changes have been brought about by the good work of MCA, the Indian government and the independent regulatory body NFRA. These changes increase the scope of work with respect to auditors. This order also increases the responsibility of auditors[232].

The auditor's are required to give an opinion on the internal audit whether the internal audit tools in effective keeping in mind the size and nature of business and whether the internal reports were considered while preparing an audit report of the financial statement. This change adds an extra responsibility for the auditor. To assess the internal reports the auditor needs to use great technical and specialized skills. Although auditors are not supposed to does the non audit work and this change could pose a challenge to the auditors[233].

Auditors report should disclose all the details on resignation of the statutory auditor during their term and whether the incoming auditor has concerned the issues raised by the outgoing auditor.[234]

Report submitted by auditor should have a point of view on the ability of the company to meet short term liabilities due within a year. Opinion speed by auditor could act as a caution against concerns like bankruptcy and insolvency classification of NPA's and also could be an early warning against any financial problem coming up[235].

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[230] CA Amresh Vashisht, *NFRA a stunned the ICAI members*, TAXGURU, (August 1, 2020, 2:00, PM) https://taxguru.in/chartered-accountant/nfra-stunned-icai-members.html.

[231] The Company (auditor's report) order 2016.

[232] Company (Auditors Report) order 2020.

[233] Clause XIV, Company (Auditors Report) order 2020.

[234] Clause XVIII, Company (Auditors Report) order 2020.

[235] Clause XIX, Company (Auditors Report) order 2020.

The CARO rules 2020 try to enhance the responsibility of auditors. These rules improve the position of auditors as watchdog's in the corporate governance mosaic.

5.6 THE COMPANIES AMENDMENT BILL 2020

It seems that 2020 has been the year of amendments for the corporate sector. With amendments
brought under the provisions of Corporate Social Responsibility, Incorporation of companies, CARO 2020 etc. The Central Government has again laid down another set of amendments before the Lok Sabha on 17thMarch, 2020 by way of Companies (Amendment) Bill, 2020[236].

The amendments proposed related to auditors are generally related to substantive provisions like the amendment proposed for section 140(3) is contravention of section 140(2) the auditor would be fined for a sum not less than 50,000 and not more than 5lakhs. The upper amount of 5 lakhs has been reduced to 2 lakhs[237].

Changes have also been proposed for section 143 (15) the fine that the auditor had to pay in case of not reporting the fraud under section 143 (12) has been segregated for listed companies and other companies. The penalty levied on the auditor in case of not reporting fraud in a listed company would be five lakh and for other companies it would be 1 lakh rupees. Currently the section has a minimum limit of 5 lakh and maximum limit of 25 lakhs.[238]

The changes for proposed section 147 are the provision related to imprisonment will be deleted and provision which states that the auditor would have to pay a fine of one lakh rupees or will be imprisoned or suffer both this has been proposed to be the punishment has been substituted with just payment of fine of. 1lakh.[239]

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[236]The Companies Amendment Bill 2020(Bill No 88 Of 2020), (August, 1, 2020, 2:23 PM) http://164.100.47.4/BillsTexts/LSBillTexts/Asintroduced/88_2020_LS_Eng.pdf

[237] SECTION 140 (3), THE COMPANIES AMENDMENT BILL 2020, (August 1, 2020, 2:45 PM) http://164.100.47.4/BillsTexts/LSBillTexts/Asintroduced/88_2020_LS_Eng.pdf

[238] Section 143(12) The Companies Amendmentbill2020, (August 1, 2020, 3:33 PM) Http://164.100.47.4/Billstexts/Lsbilltexts/Asintroduced/88_2020_Ls_Eng.Pdf

[239] Section 147 The Companies Amendment Bill, 2020, (August 1,2020, 3:35 PM) 2020,Http://164.100.47.4/Billstexts/Lsbilltexts/Asintroduced/88_2020_Ls_Eng.Pdf

The amendments proposed in regard to auditors relate to substantive provisions. The interesting point to note here is that the penalty or punishments already existing have been considerably reduced in the proposed bill. The intent of the legislature here seems to reduce burden on the auditors so that their efficiency increases and can work with a free mind.

CHAPTER 6

INDEPENDENCE AND EFFICACY OF AUDITORS

The primary purpose of an audit is to provide company shareholders with an expert, independent view point about the annual accounts of the company actually reflect true picture of the financial position of a company and if they are worthy to be relied on. Independence is the main means by which an auditor demonstrates that he can perform his task in an objective manner. The Need for Auditor Independence

The auditor should be independent from the client company, so that the audit opinion will not be influenced by any relationship between them. The auditors are expected to give an unbiased and honest professional opinion on the financial statements to the shareholders.

Doubts are sometimes expressed regarding the independence of external auditors. It can be argued that unless suitable corporate governance measures are in place, a firm of auditors may reach audit opinions and judgments that are heavily influenced by the wish to maintain good relations with a client company. If this happens, the auditors can no longer be said to be independent and the shareholders cannot rely on their opinion.[240]

Auditor independence refers to the independence of the external auditor. It is characterized by integrity and an objective approach to the audit process. The concept requires the auditor to carry out his or her work freely and in an objective manner[241]

Auditors are expected to provide an unbiased and professional opinion on the work that they audit. An auditor who lacks independence virtually renders their accompanying auditor report useless to those who rely on them.

The fact is that auditors who lack independence compromise the integrity of financial markets and the reliability of information. Investors would not be willing to extend capital to companies, knowing that the audited information was performed by an auditor who is not independent. Furthermore, banks would not be willing to issue a loan for fear that the auditor might've provided a biased audit report.

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[240] *The Importance Of Auditor Independence*, PEARSETRUST, (July 29, 2020 10:00 AM) https://www.pearse-trust.ie/blog/the-importance-of-auditor-independence.

[241] Auditor independence, ICAEW, (July29,2020, 11:00AM) https://www.icaew.com/technical/ethics/auditor-independence.

6.1. FIVE THREATS TO AUDITOR INDEPENDENCE

The following are the five things that can potentially compromise the independence of auditors:

1. Self-Interest Threat

A self-interest threat exists if the auditor holds a direct or indirect financial interest in the company or depends on the client for a major fee that is outstanding. For example: The audit team is preparing to conduct its 2020 audit for ABC Company. However, the audit team has not received its audit fees from ABC Company for its 2019 audit. Issue with this is that the audit team might be tempted to issue a favorable report so that the company is able to secure a loan to settle the fees outstanding for their 2019 audit.

2. Self-Review Threat

A self-review threat exists if the auditor is auditing his own work or work that is done by others in the same firm. To understand it is the following illustration: The auditor prepares the financial statements for ABC Company while also serving as the auditor for ABC Company. By having the auditor review his or her own work, the auditor cannot be expected to form an unbiased opinion on the financial statements.

3. Advocacy Threat

An advocacy threat exists if the auditor is involved in promoting the client, to the point where their objectivity is potentially compromised. The auditor may issue a favorable report to increase the sale price of ABC Company.

4. Familiarity Threat

A familiarity threat exists if the auditor is too personally close to or familiar with employees, officers, or directors of the client company. The example for this is ABC Company has been audited by the same auditor for over 10 years and the auditor regularly plays golf with the CEO and CFO of ABC Company. The auditor may have become too familiar with the client and, thus, lack objectivity in their work.

5. Intimidation Threat

An intimidation threat exists if the auditor is intimidated by management or its directors to the point that they are deterred from acting objectively. The auditor’s independence

may be compromised, as ABC Company is their biggest client and they, quite naturally, do not want to lose such a client. Therefore, the auditor may issue a report that appeases ABC Company.

6.2. INDEPENDENCE OF MIND AND APPEARENCE

Independence is a state of mind as well as personal character. It really cannot be insured are created by any rules or laws. Independence cannot be confused with superficial standards of independence imposed by law. Legal standards may give to a person to be independent but the quality of independence remains an altar unless and until it starts to reflect from mind. According to the code of ethics for professional Accountants issued by Indian federation of accountants defines auditor independence as independence of mind and independence of appearance.[242] Independence comprises independence of mind and independence in appearance. Independence of mind is the state of mind that permits the performance of an audit without being affected by influences that compromise professional judgment, thereby allowing an individual to act with integrity and exercise objectivity and professional skepticism.[243]

Independence in appearance is the absence of circumstances that would cause a reasonable and informed third party, having knowledge of the relevant information, to reasonably conclude that the integrity, objectivity, or professional skepticism of the audit organization or member of the audit team had been compromised. [244]

By nature, auditors are supposed to be independent. Since independence is a state of mind and it could vary from auditor to auditor, regulators cannot thrust independence upon an auditor but can only expect that they act independently all the time. For the last couple of decades, regulators around the world have thought of options that would act as a firewall for auditors' to act independent — compulsory rotation of auditors being one of the

[242]Code of ethics for professional accountants, IFAC, (August 2, 2020, 2:53 PM) https://www.ifac.org/system/files/publications/files/ifac-code-of-ethics-for.pdf .

[243]Guidance note on independence of auditors, council of Indian institute of Chartered Accountant, ICAI, (August 2, 2020, 2:53 PM) http://kb.icai.org/pdfs/PDFFile5b28d196f0f1d1.64038450.pdf .

[244] Ibid.

options and also a mandatory provision under Companies Act.[245] To avoid conflict further conflict of interest the companies act provide for provisions such as barring the auditors from performing a non audit work like bookkeeping, internal management of finances etc,[246] The act also has some disqualifications for a person to be auditor so that there is no factor influencing the auditor for personal gains and creating conflict of interest.[247]

The auditor rotation is to ensure that the auditor does not become too cozy with their client and the Companies Act, 2013 introduced a system of compulsory changing auditors after a particular point of time for a certain class of companies. On the ground, it has been observed that rotation of auditors is happening based on barter transactions in which audit firms mutually agree to give up and take audits amongst themselves Section 139 provides for mandatory rotation of auditors who have discharged their services for a corporation for five successive years in case of individual auditor and for a term of ten years i.e. two consecutive five year term years. This provision has to be compulsorily followed by all the listed entities, unlisted entities of public nature having an amount of rupees ten crore or more resulting from initial issuance of shares, entities which are private having capital of twenty crore or more raised from initial issuance of shares. This provision also applies to companies that have borrowing from financial institutions, banks of public deposits of 50 crore or more but the share capital is less than 10 crore in case of unlisted public companies and 20 crore in case of private companies. This provision also prohibits any relationship between the incoming auditor and outgoing auditor.[248]

This provision helps to enhance auditor independence by making the chances of collusion between management and auditor considerably low. The rotation of auditors will not let any personal relationship to be built between the management and auditor and the management also can not influence the auditor in its decision. The auditor would be free from any influences affecting their reporting about the financial health of the company.

[245] Mohan R Lavi, *independent auditors*, THE HINDU BUSINESSLINE, January 15, 2018 (August 4, 2020, 6:00 PM) https://www.thehindubusinessline.com/opinion/independent-auditors/article9395190.ece
[246] Section 144, Companies Act, 2013.
[247] Section 143, Companies Act, 2013.
[248] Section 139 , The Companies Act, 2013.

Although this section does not guarantee that the auditor would work independently but it does provide the correct route for the auditor to be free from any influences.

6.2.1. Disqualification of Auditor pertaining to conflict of interest

Section 141 (3) (d) states that a person appointed as an auditor should not have any personal or monetary interest or security in a company enjoying their expertise it also important to note that the abovementioned interests pertain to the company being audited and its subsidiary. A person stands disqualified even if such a person's kith and kin or partner has personal or pecuniary interest or security in the company or its subsidiary or associate. The only exception to this rule is that the holding of such security or interest is exempted to the extent of Rs. 1 Lakh. Other condition mentioned in the section is that if the person who wants to be appointed as an auditor owes that company or its subsidiary or associates a debt above Rs. 5 Lakh. A person wanting to be appointed as auditor cannot be a guarantor of any debt taken amounting to one lakh or more, by someone else from the company he/she is auditing or wants to make an auditor in. This section mandates almost all the conditions that could cause conflict of interest and counts it as disqualification for a person to be appointed an auditor in that particular company.[249]

Prescribed amounts have been inserted by the Companies (Audit and Auditors) Rules, 2014[250]. Under the 1956 act, disqualification was with respect to holding security, being indebted or giving guarantee for indebtedness but only with respect to the company. But the 2013 act has brought all the entities namely subsidiary, holding and associate companies under this because dealing with any of the above entities may lead to a conflict of interest with the concerned company also. This is a new disqualification added in the companies act, 2013. It is important to note that the limits enshrined here seem to be very low and disqualifies auditors. But an interest of Rs. 6 Lakh in a Rs. 10,000 Crore company does not seem to be much. But in the difficulty of laying down formula for a

[249] SECTION 141 (3)(d), The Companies Act, 2013.

[250] Ministry of Corporate Affairs {Companies (Audit and Auditors) Rules} [2014] G.S.R. 246(E) Rule 10(1)(2) (3), http://www.mca.gov.in/MinistryV2/report+of+the+expert+committee+on+company+law.html

wide range of companies, it has been suggested that the present position of financial limits is workable[251]

Section 141(3)(e) stops a person or a firm who is personally or involved through a kith or kin in a commercial relation with the company and its related companies. But it is laid down in the section that if a person is disqualified to be an auditor of either the subsidiary or holding company of the concerned company, then he can't be the auditor of the company whose subsidiary or holding company disqualifies the auditor on the ground of having a commercial or business relationship with it.[252]

The term business relation has a very wide application and includes ample number of instances in its ambit. The term "business relationship" has been defined under the Companies Rules, 2014[253]. According to rules, a business relationship includes any transaction that has been entered upon for the purpose of business or commerce.

Section 143 has very elaborate grounds for disqualification of the auditors. The disqualifications cover backgrounds where conflict of interest can occur and influence the auditor's independence to present true and fair report because of their business relations or liability towards a company to collude with the management. The principle of "intimidation threat" is likely to operate on the audit firm or auditor when it is reliant on a few clients for its survival. The auditors in hope for personal gains from the company can collude with the management and present an audit report which is not true to its nature. This provision is trying to avoid conflict of interest for the auditor caused due to being stuck between the choice of personal gain and representing a true picture to the investors of the company about the financial health of the company. The clouded judgment of an auditor could reflect badly upon the choices made by the investors regarding the investment made in a company based upon the audit report given by the auditor.

Performance of non audit service

Section 144 of the Companies Act gives a list of services which cannot be carried out by an auditor for a company after being appointed as a statutory auditor of the company.

[251] Ministry of Corporate Affairs, Report Of The Expert Committee On Company Law: Disqualification of Auditors (para 10.7), (August 3, 2020, 12:52 PM) http://www.mca.gov.in/MinistryV2/report+of+the+expert+committee+on+company+law.html
[252] SECTION 143(3)(e), The Companies Act, 2013.
[253] Ministry of Corporate Affairs (Companies (Audit and Auditors) Rules) [2014] G.S.R. 246(E) Rule 10 (4).

The provision says that an auditor can only provide services which are already reviewed and allowed by board or subcommittee of audit. The exception to this rule is list of services mentioned by the statute which the auditors are barred from performing:[254]

Objective of provision 144 is preventing any extra incentive from the company to affect the independence of the auditor. The prohibition of non-audit services comes from the two principles, namely, the self-review threat and advocacy threat. In order to gain some extra incentives by the company the auditor gets involved in the internal matters and management which could affect the independence of the auditor. Going too far into non audit work could lead to compromising the objectivity of the auditor.

6.3. INDEPENDENCE OF AUDIT COMMITTEE

The audit committee has been formed to act both as a conduit of information supplied by the management to the auditors, and at the same time to insulate the auditor from the pulls and pressures of the management. The audit committee is therefore required to be "independent" of the management and has the responsibility of deciding the scope or work, including the fixation of audit fees and determination of the extent of non-audit services. The basic idea is to make the auditor not to be dependent on inside management, both in terms of discharge of its functions as well as in terms of its survival.[255]

Section 177 of the Companies Act 2013 laid down the constitution of audit committee compulsory of every listed company having paid up capital of more than 10 crore, turnover exceeding hundred crore or a loan or borrowing or debentures or deposits of more than 50 crore.[256]

The Companies Act mandates for audit committee to consist of members of board i.e. directors who should not be more than three in number with outside directors being majority members of the committee. A person needs to be a person you could understand and read the financial statements of the company. This provision tries to ensure

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[254]Section 144, The Companies Act, 2013

[255]Dr. Amarjeet Kaur Malhotra,*Audit Committee Characteristics and Earnings Management: Evidence from India*, 6(2), ISSN, 2162, 2162-3082 2016.

[256] Rule 6 (committees of the board) of the companies (meetings of the board and its powers) rules 2014.

independence of the audit committee by making the independent directors majority members of the committee. Outside directors are free from management and do not have any kind of relations with the company. Independent directors are appointed to maintain the credibility and corporate governance standards in a company. Majority of independent directors being part of the audit committee mandated by the statute is showing the objective of the provision to ensure the independence of the audit committee who in turn try to ensure the independence of the auditor from internal control[257].

The size and composition of the audit committee is such that the independent directors form majority. This implies that the decisions taken by the audit committee are not influenced by the internal management are the board of directors. The presence of independent directors on the audit committee instills confidence in the investors that auditors and Audit committee are independent of the management. The investors believe the report presented in the AGM regarding financial health of company to be true owing to the independence of the audit committee. The Audit committee can be a toothless tiger at times, as auditors just have the right to be heard and not to vote in a meeting. Moreover, the committee can only give recommendations on the appointment and remuneration of the auditors which can be accepted or rejected by the board. In order to ensure transparency and disclosure the act has mandated in a provision that the board committee has to disclose the reason for not going by recommendations given by audit committee in report of directors.[258]

6.4. EFFICACY OF AUDITORS

In English language the word efficacy means the ability to produce a desired or intended result. Going by the simple meaning in English, auditor efficacy can be defined as the ability of an auditor to produce an audit report of the financial statements which is true and fair to its nature and has been made after following all the procedural arrangements, quality control and quality assurance. Efficacy is the brainchild of independence in case of auditors. For an auditor to perform an effective audit he or she should be independent

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[257] Supra Note 160.

[258] Section 134(3), The Companies Act 2013.

and not influenced by any factors. An effective audit report is free from any discrepancies and it is true to its nature with no scope of any fraud happening.

Corporate governance has been developing for decades now auditors are the Watchmen of corporate governance structure. The investor confidence is maintained only if an auditor is efficacious. In recent times the efficacy and independence of the auditor has been under scanner after high magnitude frauds like PNB scam and IL&FS were unveiled in 2018 and 2019. The auditors have been questioned by the regulators and even authorities like SIFO were involved in the interrogation for the huge frauds committed. In the recent fraud scam IL&FS audit firms Deloitte and KPMG who were auditors for IL&FS have been questioned by the regulator and were grilled by the media for their role in the IL&FS fiasco[259].

The independence of auditor has recently been challenged in the case of the Marquee financial services company of the Anil Dhirubhai Ambani Group. PwC resigned as the auditor of the marquee financial group.[260] There were reports of this disagreement between the Reliance capital management and PWC auditors on some transactions undertaken by the management. Auditor resignation as an extreme case is usually a signal of some discrepancy in the company's accounts or management's intervention in auditor independence and creating hindrance for the auditor to do their job[261].

The Companies Act 2013 provided for measures to enhance auditor independence like the constitution of audit committee restriction on non audit services. A proper and effective audit can take place only when the auditors are independent and take their decisions with full objectivity. Unfortunately, these measures taken under the companies act have failed to stop accounting frauds and auditing failures. The governments and regulators worldwide have shied away from addressing the underlying malaise that

[259] Sugata Ghosh, *Lessons for India from the IL&FS fiasco*, ET, September 2, 2019, (August 5, 2020, 2:30 PM) https://economictimes.indiatimes.com/industry/banking/finance/lessons-for-india-from-the-ilfs-fiasco/articleshow/70946077.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=cpps

[260] Soumeet Sarkar**,** *Reliance Capital, Home Finance: PWC Resignation Letters Point To Suspicion Of Fraud*, BLOOMBERGQUINT, (August 5, 2020, 2:30 PM) https://www.bloombergquint.com/economy-finance/reliance-capital-home-finance-pwc-resignation-letters-point-to-suspicion-of-fraud .

[261] Vinod Mahanta & Sachin Dave,*A slew of systemic and cultural issues that threw top auditors off balance*, ET, June 23, 2019, (August 5, 2020, 7:30 PM) https://economictimes.indiatimes.com/industry/services/consultancy-/-audit/a-slew-of-systemic-and-cultural-issues-that-threw-top-auditors-off-balance/articleshow/69907442.cms?utm_source=contentofinterest&utm_medium=text&utm_campaign=

compromises the independence of auditors. Audit is carried out in Public interest so that the shareholders and investors make an informed choice about their hard earned money. Appointment and remuneration of the auditors should be free from management of the company being audited by them. The present dispensation for the appointment of auditors through an audit committee is under criticism the world over, despite regulatory and legal stipulations on maintaining the independence of such an audit committee. In reality, the "cultural fit" of auditors, the chemistry they share with the management, tends to get precedence in appointment. This way, the ability of auditors to remain objective and professionally skeptical is severely compromised.[262]

6.5. LEGAL CHANGES TO ENHANCE THE INDEPENDENCY

In order to enhance auditor independence and efficacy the government of India has decided to make some regulatory changes in its existing legal system.

6.5.1 NFRA

The auditors and audit firm have been portrayed as the main culprit in the corporate governance failure and frauds that have been happening. The dent that Satyam scam gave to the auditing profession was irreparable and the recent scams like PNB and IL&FS have just worsened the wound caused to the auditing profession. After the PNB scam the government decided to bring some regulatory changes and set up the National financial reporting authority (NFRA) which replaced the Institute of Chartered Accountants of India (ICAI) as regulator for the auditors.

National financial reporting authority is an independent body constituted under section 132[263]. The objective of Government of India behind constitution of such a body was restoring faith of public and investors in monetary reporting of an entity. Setting up a separate body to assist and enforce legislations and standards relating to accounting and

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[262]Ashok Haldia,*The case for a new framework to ensure auditor independence*, LIVEMINT, (Aug, 10, 2020, 10:00 AM), https://www.livemint.com/opinion/online-views/opinion-the-case-for-a-new-framework-to-ensure-auditor-independence-1564075477312.html

[263] Supra note 222.

auditing. NAFRA will also be an institutional oversight over the auditors in order to improve transparency and protect interests of stakeholders. Auditor independence will also be enhanced for effective auditing and reporting the truth about monetary status of any corporation audited.

6.5.2 Initiative by the Ministry of Corporate Affairs

In order to enhance the auditor independence the Ministry of corporate affairs has taken an initiative by inviting comments via email. A consultation paper has been uploaded on the official website of the corporate ministry. The objective of the paper is to examine the current provisions relating to auditor independence and make amendments to such provisions to enhance auditor independence and efficacy. The object of inviting comments by the concerned ministry was done to obtain viewpoint of other government departments and regulatory authorities on suggestions relating to amendment in existing law to enhance audit, independence and accountability. Suggestions given in the consultation paper are related to elimination of self interest threat, self review threat, advocacy threat, similarity threat and intimidation threat to independence of auditors. Some Suggested measures to follow are appointment of auditors by external authorities, prohibition of business relationships, restriction on personal relationships, and stringent quality review procedure with informed confidentiality of information etc[264].

6.5.3. Companies audit report order 2020 (CARO)

The format of auditor's report is governed by company (Auditors report) order 2016[265], CARO 2016. In recent years there have been significant negative impacts on the financial sector like the PNB scam happening followed by high magnitude IL&FS scam. This led to losing confidence of investors and shareholders in the audit reports of the company. In the light of recent events the Ministry of corporate affairs has been very active so that

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[264] Ministry of Corporate Affairs, notice inviting comments on the consultation paper to examine the existing provisions of law and make suitable amendments therein to enhance audit independence and accountability, Dated the 6th February, 2020,
http://www.mca.gov.in/Ministry/pdf/Comments_08022020.pdf)

[265] Supra Note 232

none of these scams are repeated in future. This good work is done by corporate ministry, Government of India after consulting National Financial Regulatory Authority notified companies (auditor report) order 2020[266]. In order to regain the confidence of investors CARO 2020 is following the line of its predecessor but it has made changes in the extent and manner of disclosure with respect to already existing rules. CARO 2020 will bring in a new standard of transparency in reporting the financial position of a company being audited to whose report the rules apply. The standards are raised and are a challenge to auditors to work more efficiency. In order to bring more transparency the auditors will have to work more independently and in an efficacious manner.

[266] Supra Note 233.

CHAPTER 7

CONCLUSION & SUGGESTIONS

Corporate governance has been developing for the last two decades in India. Different authorities like Securities and Exchange Board of India, The Ministry of corporate affairs the Government of India are working towards improving the standards of corporate governance to bring it in line with international standards especially those followed in the US and UK. The Indian corporate governance has been needed on the lines of developed countries like the USA and United Kingdom. Disclosure and transparency are the pillars of corporate governance and auditors are important masons of these pillars. The importance of audit committee and auditors in corporate governance has been reiterated by many national and international committees formed to make recommendations on strengthening the corporate governance norms like the Cadbury committee, Hampel committee, Greenbury committee of the UK, the Birla committee and the Narayan Murthy committee of India.

Corporate governance is very necessary for smooth functioning of a corporation. It is a tool to enhance greater good for all associated with the Corporation. The Auditors and Audit committee are the ultimate watchdogs of corporate governance in a company their role can be compared to that of security guards who protect their hirers to best of their abilities in any condition. In the same way auditors and audit committee protects the company they are auditing from financial losses and dead ends. The auditors can work to fullest when proper corporate governance norms are followed and they are granted full independence. The failure to follow proper corporate governance norms results in corporate governance failure. There is evidence of such corporate governance failures like Enron and Satyam computers in the past and PNB and IL&FS scam in the present show effects of not following corporate governance can lead a company from riches to rugs.

Auditors can also be compared to oil used in machinery to keep the machine well greased for smooth functioning, in the same way auditors examining financial viability of a company so that it keeps on working and does not come crumbling down because it

cannot sustain the business owing to financial crisis. It will be correct to observe that failure of auditors to detect frauds and discrepancies in financial statements leads to the fall of company eventually; there are enough proofs from the recent and past times that are examples of the same. Auditors are climbing up the ladder in corporate governance mosaic and there is need to protect their independence to enhance their efficacy. The legislation that followed the Enron debacle in the USA had provisions that regulated and controlled auditors and ensured auditor independence. In India, SEBI can be called an agent of corporate governance as it has taken many initiatives and constituted different committees to give recommendations on strengthening the corporate governance norms in India. All these committees highlighted the role played by the auditors in strengthening corporate governance and the necessity for auditor independence to do the same. .

Auditor independence and efficacy go hand in hand but this independence can be enhanced when audit committee supports auditor independence. The recommendations and comments that are made by auditors only reach the management with the help of audit committee which act as bridge between board and auditors. The independence of this committee is very important and should be enhanced and ensured. The legislation in India have provisions that try to make sure it happens, Companies Act 2013 made it a mandatory requirement for all the listed companies to have audit committees. The need for an audit committee was stressed upon by so many legislations and committees because the audit committee acted as financial eyes for the management and is a bridge between auditors and the management. The audit committee is responsible for true and fair disclosure of the financial health of the company. Auditor independence in a company having an audit committee has to be ensured by such committee.

In practicality audit committee is not that efficient and independent. Although, Companies Act has provision that has made it mandatory for listed companies to have the audit committee. It would not be wrong to call all the audit committee a toothless tiger, even though their existence is mandatory but all they do is give recommendations to the board of directors on appointment, remuneration, internal control, financial control and Management in a company. They don’t have an actual say in anything, they are made responsible for the disclosure of financial health of the company, but they mere puppet in the hands of the directors with no voting rights so the credibility of disclosure comes

under scanner. The composition of the committee is such that the independent directors are majority members of the committee. The purpose of the act behind incorporating such a provision was to enhance the independence of the audit committee but the committee does not have any major right or overriding authority and can't even function without establishing communication with the board regarding the decisions it wants to take.

Auditors and audit committee’s independence is very important. It can be said that auditors offer public service by providing correct status of financial position of a company to its investors and shareholders, ultimately helping these people in making an informed choice about their hard earned money. They entrust the auditor's judgment regarding the financial position of the company and then make an informed choice regarding investment with their hard earned money. This obligates the law to ensure auditors independence so that they can use their professional skills for public good.

The Companies Act 2013 and its predecessor had provisions to enhance auditor independence like bifurcation between audit and non audit services, disqualification of auditors to avoid conflict of interest on basis of personal business relationships. All these provisions were proving to be not enough as the role of auditors in corporate governance failures was inevitable. The reputation of auditors has been spoiled from the time of Satyam computers. The recent scams at Punjab National Bank and IL&FS have just added some more dirt to the profession. Auditor independence is of prime importance for the quality of work that they have to produce. For an auditor to conduct an effective and efficient audit his or her being independent is very important. The involvement of any factor that would lead the auditor to be in a fix i.e. choosing between his personal And professional duties like, some extra financial benefits could be a reason for the auditor to collude with the management and become a party to fraud. Auditors need to be free from all these influences to conduct an effective audit which would be trusted by the investor's of the company. The need to change the existing laws and regulations has become the need of the hour to ensure auditor independence for effective audit The Government of India and Ministry of Corporate Affairs has been playing an active role in strengthening corporate governance and have been amending legislations in order to bring it in line with the international standards and to avoid huge frauds and scams. MCA inviting comments and suggestions to enhance auditor independence is one such good initiative. Setting up

of national financial regulatory authority as an independent regulator of auditors is one of the steps to enhance auditor independence by the government. The recent scams have made the investors more skeptical about the audit reports. Audit should be done efficiently and effectively and auditor independence is the only way to do so.

Suggestions:

Auditors are the watchdogs of corporate governance and here are some suggestions to enhance auditor independence and efficacy:

- The appointment of auditors should be done free from management of the company being audited.
- The audit committee should be given authority for decisions related to audits.
- The members of the audit committee should be given the right to vote on decisions involving finance of the company.
- The fees of the auditor should be based on time period and expertise required for the audit.
- Auditors shall submit a monthly audit report to the audit committee for better effectiveness of the report.
- Stricter rules should be implemented for quality compliance.
- The member of audit committee should be given right to vote on matters related to audit and auditors.
- The period for audit rotation should be more frequent.

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