Appointment of Auditors (Sec 139) Part-1

1. Legislative background

The notes on clauses to the Companies Bill, 2011 read as follows:

"Clause 139. — This clause corresponds to section 224 of the Companies Act, 1956 and seeks to provide that a company shall appoint an individual or a firm as an auditor at annual general meeting subject to his written consent who shall hold office till conclusion of sixth annual general meeting. The manner and procedure of selection committee shall be prescribed by the Central Government. A notice of appointment should be filed with the Registrar. The clause provides for the provisions for rotation of auditors. The Central Government may prescribe the manner in which the companies shall rotate their auditors. The Comptroller and Auditor-General of India appoints auditor of Government Companies. First auditor of a company, other than a Government company is appointed by Board within 30 days of registration and in case of failure to appoint, the members at a general meeting shall appoint. In case of a Government Company or a Company owned or controlled by Government Comptroller and Auditor-General of India shall appoint auditor. In case of their failure, the Board shall appoint first auditor and in case of failure members of company in general meeting will appoint."

2. Overview of audit

Audit is an examination of accounting records undertaken with a view to establish the correctness or otherwise of the transactions reflected therein. It involves an intelligent scrutiny of the books of account of a company with reference to documents, vouchers and other relevant records to ensure that the entries made therein give a true picture of business conducted during the period under review, that every transaction has been properly authorised by the appropriate authority and that effect of all the entries in the books of account has been duly reflected in the final accounts.

The main object of audit is to ensure that the statement of accounts of the relevant financial year truly and fairly reflects the state of affairs of the company. Audit also provides a moral check on those who are entrusted with the task of running business and of keeping and maintaining the books of account of the company.

3. Need for audit

Audit of accounts is a sine qua non of any business, however big or small it may be. During the course of business the stakeholders namely proprietor, creditor,

purchaser or a seller has to deal with various financial statements. Nobody would rely on financial statements prepared by the management because this would be like having a judge for hearing a case in which he himself is a litigant. When a business is run by a proprietor himself, the need for audit may be limited because the business is under his direct control. But where the business is run by persons other than the owners in a company, an independent review of the books of account becomes absolutely necessary in order to safeguard the interest of the shareholders who with the help of the audited accounts are enabled to know how their funds have been utilised during the financial year, whether proper books of account have been maintained, whether profit and loss account discloses true affairs of the company, profit earned or loss suffered by the company and whether the balance sheet gives a true and fair view of the state of affairs of the company on the date on which it is drawn. Another reason for making audit compulsory in a company is the fact that the shareholders and the directors who are shareholders enjoy the benefit of limited liability. Audit is also a tool to safeguard the interest of the creditors.

An audit of accounts is conducted with two-fold purpose: (i) detection and prevention of errors; (ii) detection and prevention of fraud.

The difference between error and fraud is that error implies omission or commission without intention to do so which may include clerical, arithmetical, typographical whereas fraud means omission or commission with intention to defraud creditors, shareholders or other stakeholders.

Audit is useful only if it is conducted by some independent and qualified authority. The auditor must possess requisite qualifications and must act in independent capacity. He should not be an employee of the company and his action should not be subject to the supervision of the management of the company. The provisions relating to audit and auditors including their qualifications, rights and powers are incorporated in Chapter X of the Act.

4. Appointment of auditor

Section 139 of the Act provides for compulsory appointment of an auditor by every company. Section 139 deals with all the cases, circumstances with respect to appointment of auditors and therefore, it is a complete code in itself with respect to appointment of Auditors.

4.1 Appointment of statutory auditor at the annual general meeting

(i) Sub-section (1) of section 139 of the Act uses the expression "subject to provisions of this chapter" which means that the provisions of sub-section (1) of section 139 are subject to other provisions of the Act contained in this chapter.

(ii) As far as operating part of sub-section (1) of section 139 of the Act is concerned, it is amply clear that every company shall, at the first annual general meeting, appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.

As per sub-rule (7) of rule 3, the meeting wherein such appointment has been made being counted as the first meeting. It further provides that such appointment shall be subject to ratification in every annual general meeting till the sixth such meeting by way of passing of an ordinary resolution.

DCA (Now MCA) Circular:

1. The issue regarding the tenure of office of auditors appointed in terms of section 224 of the Act has been under consideration of this Department for some time. The point for consideration was whether the tenure of office of the auditor expired on the last date on which the annual general meeting was due to be held in terms of section 166 of the Companies Act, 1956 or whether it expired only on the factual conclusion of the next annual general meeting held by the company. It may be stated that divergent views had been expressed by eminent lawyers in the country. The matter has been examined in great detail. The Board has come to the conclusion that the advice given by the Ministry of Law in 1955 and reiterated by that Ministry in 1958 may be followed until any contrary view is expressed by a competent Court of Law in this regard. The view confirmed is the following:

"The tenure of an auditor is laid down in section 224(1); it is from the conclusion of the annual general meeting to the conclusion of the next annual general meeting and cannot therefore be for any particular year or financial year as such. The duty of the auditor is laid down in section 227(2), where under the auditor in office has to audit,every balance sheet and profit and loss account' and every other document in it or annexed to it which are laid before the general meeting held during his tenure of office. In view of the provisions in section 224(1) there can be only one annual general meeting held during the tenure of office of any particular auditor. That also shows that the auditor's appointment is not related to any particular balance-sheet or profit or loss account or to any particular financial year."

2. The Board took into consideration the views expressed by the Ministry of Law in 1958 on the question of the competence of the auditor appointed at an annual general meeting to audit the accounts for more than one year intervening during the general meeting at which the auditor was appointed and the next annual general meeting held by the company. The Board also noted the opinion given by the Ministry of Law in 1958 that the auditor appointed for the year 1954 could audit the accounts of the company for the years 1955, 1956 and 1957 during which no annual general meeting was held.

3. In the above context, the Board decided that the tenure of an auditor appointed under section 224 of the Companies Act will continue upto the factual conclusion of the next general meeting held by the company." (Circular No. 19/73).

"It is only where an auditor is not appointed at an AGM that the Central Government can exercise the powers under section 224(3) of the Act. According to the provisions of section 224(1) of the Act, the auditors are appointed for the period beginning from the conclusion of the AGM (in which they are appointed) till the conclusion of the next AGM. The appointment of auditors is made in terms of this period and not for any financial year. The auditors shall audit all the accounts of the company which are to be placed in the next AGM. Thus, when the AGM could not be held on 29th June, 1974 the date for which it had been convened or on the adjourned date, the auditors who had audited the company's accounts for the year ended 31st December, 1973 will continue to be the auditors till the conclusion of the next AGM, whenever it may be possible to hold it, and shall be competent to audit all the subsequent accounts as authorised by the Authorised Controller which may be placed at such next AGM*[DCA (Now MCA) Circular Letter No. 35/13/74-CL-III, dated 21-11-1974]*

Concept of ratification of auditor

The Act provides for an appointment of auditor by shareholders at an annual general meeting to hold office till the conclusion of sixth annual general meeting but it mandates for ratification of auditors at every annual general meeting. The Act has introduced a new concept of ratification of auditors at every annual general meeting. The word 'ratification' is defined in the Black's Law Dictionary *[9th Edition, Page 1376]* as 'confirmation and acceptance of a previous act, thereby making the act valid from the moment it was done'. Here ratification means formal assent of shareholders for continuance as auditors.

First proviso to sub-rule (7) of rule 3 provides that the auditor appointed at annual general meeting shall be subject to ratification in every annual general meeting till the sixth such meeting by way of passing of an ordinary resolution.

Further, explanation to rule 3 clarifies that, if the appointment is not ratified by the members of the company, the Board of Directors shall appoint another individual or firm as its auditor or auditors after following the procedure laid down in this behalf under the Act.

Secretarial Standards on General Meeting (SS-2) notified to be effective from 01.07.2015 classifies business for ratification of auditor at annual general meeting, as an ordinary business.

The Companies (Amendment) Bill, 2016, proposes to omit the first proviso to sub-section (1) of section 139. Hence, the concept of ratification is proposed to be done away with.

(iii) Role of Audit Committee: As per sub-section (11) of section 139 of the Act, where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of such committee.

Section 177 of the Act read with rule 6 of Companies (Meetings of Board and its Powers) Rules, 2014 provides that the following companies are required to constitute an audit committee of the board

(i) All listed companies;
(ii) all public companies with a paid up capital of 10 crore rupees or more;
(iii) all public companies having turnover of 100 rupees or more;
(iv) all public companies, having in aggregate, outstanding loans or borrowings or debentures or deposits exceeding 50 crore rupees or more.

The paid up share capital or turnover or outstanding loans, or borrowings or debentures or deposits, as the case may be, as existing on the date of last audited financial statements are to be taken into account for the purposes of this rule.

(To be continued...)

Contents of Geeta Saar, as extracted from ICSI Premier on Company Law, is as per notified law as on 30th September, 2016.