Eligibility, Qualifications and Disqualifications of Auditors (Sec 141)

1. Legislative background

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

"This clause corresponds to sections 224(1B) and 226 of the Companies Act, 1956 and seeks to provide for appointment of only Chartered Accountant in practice as auditors. The firm whereof majority of partners practicing in India are qualified for appointment, may be appointed by its firm name to be auditor of a company. The clause further provides for the persons who are not eligible for appointment as an auditor of a company. The clause further provides that the members of the company may restrict the number of companies beyond which the auditor or audit firm shall not be auditor. An auditor who is disqualified subsequent to his appointment, has to vacate office."

Eligibility and qualification to become an auditor of a company is dealt with under subsection (1) and (2) of section 141. Further, disqualification is dealt with under sub-section (3) of section 141.

2. Eligibility and qualification of auditors

Sub-section (1) of section 141 provides that a person shall be eligible for appointment as an auditor of a company only if he is a chartered accountant.

Chartered Accountant has been defined in sub-section (17) of section 2 of the Act as under:

"chartered accountant" means a chartered accountant as defined in clause (b) of subsection (1) of section 2 of the Chartered Accountants Act, 1949 (38 of 1949) who holds a valid certificate of practice under sub-section (1) of section 6 of that Act.

Further, as per clause (b) of sub-section (1) of section 2 of the Chartered Accountants Act, 1949, "chartered accountant" means a person who is a member of the Institute. Further, sub-section (1) of section 6 of the said Act deals with certificate of practice and states as under:

"Section (6) Certificate of Practice: No member of the Institute shall be entitled to practice whether in India or elsewhere unless he has obtained from the Council a certificate of practice:

Provided that nothing contained in this sub-section shall apply to any person who, immediately before the commencement of this Act, has been in practice as a registered accountant or a holder of a restricted certificate until one month has elapsed from the date of the first meeting of the Council."

From the above, it is clear that the word "chartered accountant" has been used throughout the Act, unless the context otherwise requires, to mean a practicing chartered accountant.

Further, proviso to sub-section (1) of section 141 provides that a firm whereof majority of partners practicing in India are qualified for appointment as aforesaid may be appointed by its firm name to be auditor of the company. In other words, the proviso clarifies that only such audit firms would be eligible to be appointed as auditor of the company where majority of the partners practicing in India are chartered accountants as defined in subsection (17) of section 2 of the Act.

As per sub-section (2) of section 141, where a firm including a limited liability partnership (LLP) is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorized to act and sign on behalf of the firm. This sub-section further finds reference in section 145 which provides for signing and certification audit reports and other documents.

3. Disqualifications of auditors

As provided in sub-section (3) of section 141, the following persons shall not be eligible for appointment as an auditor of a company, namely:

a) a body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008; As per clause (a), all body corporates except LLPs are disqualified be an auditor of a company.

b) an officer or employee of the company;

As per clause (b), an officer or employee of the company is disqualified to be an auditor of the company. In clause (b), the words "officer" and "employee" have been used by the legislature. The word 'officer' has been defined inclusively in sub-section (59) of section 2 of the Act; however the word "employee" has not been defined in the Act.

As per sub-section (59) of section 2, "officer" includes any director, manager or key managerial personnel or any person in accordance with whose directions or instructions the board of directors or any one or more of the directors is or are accustomed to act. The definition of the word officer is wide in view of the fact that the legislature has used the word "includes", and also the phrase "accustomed to act". The concept of "accustomed to act" has been covered in detail in commentary under definition section.

In the matter of Mithilesh Kumar Dubey vs .Brahattakar Krishi Saakh Sahakari Samiti Mydt , Atari Khejda *[(06 . 04 . 2010 - MPHC)]* , the MP High Court stated that, since the term "employee" has not been defined under the Act, hence, we are borrowing the meaning of word "employee" from different dictionaries. "In Black's Law Dictionary, the term "employee" has been explained as under :-One who works

for an employer; a person working for salary or wages; applied to anyone so working. According to Prem's Judicial Dictionary, the word "employee" contemplates the existence of a relationship of master and servant. As per Webster's third New International Dictionary Volume I, "employee" would mean one employed by another usually in a position below the executive level and usually for wages, in labour relations, any worker who is under wages or salary to an employer. The term "employee" has also been elucidated in the Legal Glossary published by Government of India. According to which, employee means one who is employed by another, especially by a business concern or government; one employed in a position below the executive level. Hence, according to us, the term "employee" means any person who is employed for wages in any kind of work, manual or otherwise, in or in connection with the work of an establishment". *[Mithilesh Kumar Dubey vs .Brahattakar Krishi Saakh Sahakari Samiti Mydt, Atari Khejda (06 . 04 . 2010 - MPHC)]*

Where a Chartered Accountant is employed whole-time, he is an employee of the company. In other cases, generally speaking, there would appear to be only a contract for service and not a contract of services between the company and the Chartered Accountant. But, an auditor of the company engaged as its incometax consultant either on payment of ad hoc fee or fees plus retainer or on fixed periodical remuneration, is not an officer or employee of the company; hence he is not disqualified under section 226(3)(b) (now section 141(3(c). *[MCA Circular No. 8/1/57-PR dated 11th July, 1957]*

The internal auditor appointed by a company is in the position of an employee; hence he is disqualified for the appointment as a statutory auditor of the company vide section 226(3) (b) (now section 141(3(c)). *[MCA Circular No. 29 of 1976, dated 27th August, 1976]* Further, as per section 144, statutory auditor can not act as internal auditor of the company.

c) a person who is a partner, or who is in the employment, of an officer or employee of the company;

This disqualification is wider than clause (b) and covers even a person who is a partner or who is in the employment, of an officer or employee of the company. As discussed in clause (b) above, the term 'employee' is wider of the two.

d) a person who, or his relative or partner—

(i) is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company:
Provided that the relative may hold security or interest in the company of face value not exceeding one thousand rupees or such sum as may be prescribed;

Clause (d) is attracted in case a person who, or his relative (as defined in clause (77) of section 2) or his partner is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company.

The Companies (Amendment) Bill, 2016 proposes to insert the following explanation for defining the term "relative":

'Explanation.—For the purposes of this clause, the term "relative" means the spouse of a person; and includes a parent, sibling or child of such person or of the spouse, financially dependent on such person, or who consults such person in taking decisions in relation to his investments;';

Therefore, following scenarios are covered:

- Any security (securities) of the company or its subsidiary, or of its holding or associate company or a subsidiary of its holding company (i.e. fellow subsidiaries).
- Interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of its holding company (i.e. fellow subsidiaries).

Proviso to sub-clause (i) of clause (d) provides that the relative may hold security or interest in the company, of face value not exceeding Rs. 1000 or such sum as may be prescribed. Further, As per sub-rule (1) of rule 10, for the purpose of proviso to sub-clause (i) of clause (d) of sub-section (3) of section 141, a relative of an auditor may hold securities in the company of face value not exceeding Rs. 1 lakh.

First proviso to sub-rule (1) of rule 10 provides that the condition under this subrule shall, wherever relevant, be also applicable in the case of a company not having share capital or other securities.

The word "securities" has been defined in clause (81) of section 2 of the Act. However, the word "interest" has not defined in the Act. The word "interest" cannot be read in isolation and interpreted in isolation and hence, it has to be read in context of the words "face value". Therefore, as face value being the sole criteria, the word "Interest" has to be read in context of "voting power" wherever required. Suggested replacement: The word 'interest' is a term wider than the term "securities". The said term demands a contextual interpretation. This 'interest' appears to be the same as interest being dealt with in section 44.

If the person to be appointed or his partner holds even a single share (or other securities) of a company, he is not eligible to be appointed as an auditor. However, if a relative of such person holds securities of face value not exceeding Rs. 1 lakh, then such person shall be eligible to be

appointed as auditor subject to other clauses of sub-section (3) of section 141.

It is pertinent to note that, in order to attract sub-clause (i) of clause (d), the person or his relative or his partner should hold securities or interest in such securities individually and not in any other manner. Suggested replacement: While the section does not specify whether the securities or other interest is required to be held individually, going by the apparent intention of legislature, joint or other holding may also lead to incurring of disqualification.

Further, as per 2nd proviso to sub-rule (1) of rule 10, in the event of acquiring any security or interest by a relative, above the threshold prescribed, the corrective action to maintain the limits as specified above shall be taken by the auditor within 60 days of such acquisition or interest.

Therefore, auditor shall not stand disqualified immediately on acquisition of securities or interest above the threshold by his relative. He would be required to take corrective action to maintain the limits within 60 days from the date of acquisition of securities or interest above the threshold.

(ii) is indebted to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of such amount as may be prescribed; or

As per sub-rule (2) of rule 10, for the purpose of sub-clause (ii) of clause (d) of sub-section (3) of section 141, a person who or whose relative or partner is indebted to the company or its subsidiary or its holding or associate company or a subsidiary of such holding company, in excess of Rs. 5 lakh shall not be eligible for appointment.

In case of appointment of auditor, indebtedness of the auditor or his relative or partner as on the date of appointment to be considered. Post appointment, it is imperative for an auditor to remain within the limit of Rs. 5 lakh as once there is a breach of this limit, there is immediate disqualification and resultant casual vacancy as stipulated in sub-section (4) of section 141.

As per ICAI Notification No.1-CA(7)/63/2002 *[ICAI Notification No.1-CA(7)/63/2002 dated 2nd August 2002 Available at http://www.icai.org/post.html?post_id=2016]*,A chartered accountant shall be deemed to be guilty of professional misconduct if he "accepts appointment as auditor of a concern while he is indebted to the concern or has given any guarantee or provided any security in connection with

the indebtedness of any third person to the concern, for limits fixed in the statute and in other case for amount exceeding Rs 10,000".

(iii) has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, for such amount as may be prescribed

As per sub-rule (3) of rule 10, for the purpose of sub-clause (iii) of clause (d) of sub-section (3) of section 141, a person who or whose relative or partner has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, or its subsidiary, or its holding or associate company or a subsidiary of such holding company, in excess of Rs. 1 lakh shall not be eligible for appointment.

As per Black's Law Dictionary [9th Edition, Page 773] "Guarantee" means "1. The assurance that a contract or legal act will be duly carried out. 2. guaranty (1) 3. Something given or existing as security, such as to fulfill a future engagement or a condition subsequent."

Section 126 of the Indian Contract Act, 1872 explains Contract of guarantee', 'surety', 'principal debtor' and 'creditor' as under:

- A 'contract of guarantee' is a contract to perform the promise, or discharge the liability, of a third person in case of his default.
- The person who gives the guarantee is called the 'surety';
- the person in respect of whose default the guarantee is given is called the 'principal debtor', and the person to whom the guarantee is given is called the 'creditor'.
- A guarantee may be either oral or written.

e) a person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company or subsidiary of such holding company or associate company of such nature as may be prescribed;

The relationships covered in this clause are the direct relationships of the appointee with the company. For the purpose of clause (e) of sub-section (3) of section 141, the term "business relationship" shall be construed as any transaction entered into for a commercial purpose, except:

(i) commercial transactions which are in the nature of professional services permitted to be rendered by an auditor or audit firm under the Act and the Chartered Accountants Act, 1949 and the rules or the regulations made under those Acts;

(ii) commercial transactions which are in the ordinary course of business of the company at arm's length price - like sale of products or services to the auditor, as customer, in the ordinary course of business, by companies engaged in the business of telecommunications, airlines, hospitals, hotels and such other similar businesses.

Hence, if any services are rendered in contravention of section 144 of the Act, the said will be termed as "business relationship" and the auditor will be disqualified. This is further supported by disqualification as provided in clause (i). Further, for exemptions in sub-clause (ii), it appears that the businesses specified are dealing in primarily public goods characterized by non-rivalrous consumption.

f)a person whose relative is a director or is in the employment of the company as a director or key managerial personnel

The "relative" of the auditor is to be construed as per clause (77) of section 2. The words "director" and "key managerial personnel" are defined in clause (34) and (51) of section 2 of the Act.

g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than 20 companies [other than one person companies, dormant companies, small companies and private companies having paid-up share capital less than Rs. 100 Crores] *[Inserted vide notification dated 5th June 2015].*

The relaxation provided under this clause (g) is only for appointment in a private company.

h) a person who has been convicted by a court of an offence involving fraud and a period of 10 years has not elapsed from the date of such conviction;

The Court, for the purpose of this clause is any court having competent jurisdiction to pass such order. Such court may or may not fall under the provisions of clause (29) of section 2. Any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialised services as provided in Sec. 144.

This clause apparently alludes to the nexus of the person with the entities. As an individual or an LLP proposed to be appointed cannot have either subsidiary or associate company, the other entity is the term with wider implications.

The Companies (Amendment) Bill, 2016 proposes to bring clarity on the said point by substituting the clause (i) as follows:

(i) a person who, directly or indirectly, renders any service referred to in section 144 to the company or its holding company or its subsidiary company.

Explanation.—For the purposes of this clause, the term "directly or indirectly" shall have the meaning assigned to it in the Explanation to section 144.'

4. Vacation of office

As per sub-section (4) of section 141, where a person appointed as an auditor of a company incurs any of the disqualifications mentioned in sub-section (3) of section 141 after his appointment, he shall vacate his office as such auditor and such vacation shall be deemed to be a casual vacancy in the office of the auditor. It is pertinent to note that only for disqualification of holding security or interest in the company above specified threshold by relative of auditor under sub-clause (i) of clause (d) of sub-section (3), curative period is available. All other disqualifications are immediate.

For appointment of new auditor in case of casual vacancy, the company would be required to follow procedure as laid down in sub-section (8) of section 139 of the Act.

5. Punishment and Compoundability

For contravention by the company of any of the provisions of this section, the same is punishable as provided in sub-section (1) of section 147. It should be noted that subsection (2) of section 147 which provides for punishment to auditor does not mention section 141 amongst the list of sections mentioned therein. Hence, for contravention of this section by an Auditor or Firm, section 450 of the Act will be applicable and compounding will not be available for the same.

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