

Auditor not to render certain services (Sec 144)

1. Legislative background

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

'This is a new clause and it seeks to provide that an auditor can do such other services as approved by the Board or audit committee. The clause further provides for the services which the auditor cannot perform, directly or indirectly to the company or its holding company, subsidiary company or associate company.'

JJ Irani Committee Report, 2005 also made this recommendation in its Chapter IX (Accounts and Audit), Point 26 in the following words:

'The Committee took note of the fact that rendering of non-audit services by Auditors of the Company is a matter of general concern. The Committee was of the view that rendering of all services by the Auditors which were not related to audit, accounting records or financial statements, should not be prohibited from being rendered by the Auditors subject to a prescribed threshold of materiality. All non-audit services may however be pre-approved by Audit Committee where such a committee is mandated or in existence.

An Audit firm should however be prohibited from rendering the following non audit services to its audit client and its subsidiaries:

- Accounting and book keeping services relating to accounting records.
- Internal Audit
- Design and implementation of financial information systems including services related IT systems for preparing financial or management accounts and information flows of a company.
- Actuarial services
- Investment Advisory or Investment banking services
- Rendering of outsourced financial services.
- Management function including provision of temporary staff to audit clients.'

2. Auditor not to render certain services

The prime motive of introducing the provisions under Section 144 is apparently to ensure the enhanced independence and accountability of the auditors. Guidance Note on Independence of Auditors issued by ICAI provides valuable inputs to understand the same. Para 1.9 of the said note states that "the auditor should be straight-forward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any Interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity. This is not self-evident in the exercise of the reporting

function but also applies to all other professional work. In determining whether a member in practice is or is not seen to be free of any interest which is incompatible with objectivity, the criterion should be whether a reasonable person, having knowledge of relevant facts and taking into account the conduct of the member and the member's behaviour under the circumstances, could conclude that the member has placed himself in a position where his objectivity would or could be impaired."

Para 2.1 of this Guidance Note further states that the Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats to independence. These are:

- (1) Self-interest threats, which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include:
 - (i) direct financial interest or materially significant indirect financial interest in a client,
 - (ii) loan or guarantee to or from the concerned client,
 - (iii) undue dependence on a client's fees and, hence, concerns about losing the engagement,
 - (iv) close business relationship with an audit client,
 - (v) potential employment with the client, and
 - (vi) contingent fees for the audit engagement.
- (2) Self-review threats, which occur when during a review of any judgment or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client. Instances where such threats come into play are:
 - (i) when an auditor having recently been a director or senior officer of the company, and
 - (ii) when auditors perform services that are themselves subject matters of audit.
- (3) Advocacy threats, which occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised, e.g. when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third party disputes.
- (4) Familiarity threats are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests. This can occur in many ways:

- (i) close relative of the audit team working in a senior position in the client company,
 - (ii) former partner of the audit firm being a director or senior employee of the client,
 - (iii) long association between specific auditors and their specific client counterparts, and
 - (iv) acceptance of significant gifts or hospitality from the client company, its directors or employees.
- (5) Intimidation threats, which occur when auditors are deterred from acting objectively with an adequate degree of professional scepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.”

An auditor shall provide to the company only such other services as are approved by the board of directors or the audit committee, but which shall not include any of the following services

- (a) accounting and book keeping services;
- (b) internal audit;
- (c) design and implementation of any financial information system;
- (d) actuarial services;
- (e) investment advisory services;
- (f) investment banking services;
- (g) rendering of outsourced financial services;
- (h) management services; and
- (i) any other kind of services as may be prescribed. Such services shall not be rendered directly or indirectly to the company or its holding company or subsidiary company.

3. Providing services to associate companies

It is pertinent to note that the services cannot be provided directly or indirectly to the company or its holding or subsidiary company. Associate company is out of purview of this provision and therefore, such services may be provided to associate companies of the company or its holding or subsidiary company.

4. Rendering services “directly or indirectly”

As per explanation to sub-section (1) of section 144, for the purposes of this sub-section, the term “directly or indirectly” shall include rendering of services by the auditor,—

- (i) in case of auditor being an individual, either himself or through his relative or any other person connected or associated with such individual or through any other entity, whatsoever, in which such individual has significant influence or control, or whose name or trade mark or brand is used by such individual;

- (ii) in case of auditor being a firm, either itself or through any of its partners or through its parent, subsidiary or associate entity or through any other entity, whatsoever, in which the firm or any partner of the firm has significant influence or control, or whose name or trade mark or brand is used by the firm or any of its partners.

The legislature has used the word “includes” and hence, this is only an inclusive list and not exhaustive. The word “indirectly” is wide in scope and every case would be required to pass through stringent provisions of this sub-section.

However, when a matter specifically falls in (i) or (ii), then it has to be specifically dealt with under (i) or (ii) and the scope of interpretation shall be limited to provisions contained in (i) or (ii) as the case may be.

The word “Connected” means “related, affiliated, associated or having something to do with” (Webster).

The phrase ‘Connected or associated’ is used in context of any person. The word ‘person’ has to be understood in the context in which the language is couched. Person here seems to be an ‘Individual’ and does not apparently include body corporate, partnership firm etc. This analogy is derived from the fact that the concept of “entity” is wide enough and covers all kind of body corporates, partnership firms etc. except individuals.

Connection, association with relatives is already covered. The definition of relatives under the Act is narrow in scope and does not include many relatives of a person though they may be very close and connected to them. However, due to usage of the words connected or associated, all relatives connected or associated would be covered within the ambit of section 144. The connection or association is not to be read alongwith the phrase “significant influence or control”. The phrase “significant influence or control” is used by the legislature only in context of the words “any other entity”.

The concept of associated/ connected was explained by the Supreme Court of India in the matter of Commissioner, Madras Hindu Religious and Charitable Endowments v. Narayana Ayyangar and Ors. [MANU/SC/0343/1965]

“The expression “associated” in s. 6(13) of Act 19 of 1951 is used having regard to the history of the legislation, the scheme and objects of the Act, and the context in which the expression occurs, as meaning “being connected with” or “in relation to”.”

As stated earlier, the phrase “Significant influence or control” has been used in context of “entity”. The concept of “significant influence or control” has been explained in the explanation under definition of associate company given in section 2 of the Act. However, here in section 144, the explanation given in definition of associate company may not be relevant and can only act as a guiding force, if

required in a particular case. The use of name or trade mark covered in both explanations is significant. Such use can be called as 'networking' of firms.

5. Compliance before closure of first financial year

Proviso to sub-section (1) of section 144 of the Act provides that an auditor or audit firm who or which has been performing any non-audit services on or before the commencement of this Act shall comply with the provisions of this section before the closure of the first financial year after the date of such commencement.

6. Further analysis of management services

The non-audit services are those services which are primarily the responsibility of the management itself and has no threaded connection with audit and assurance services.

Management Consultancy Services: As per sub-section (2) of section 2 of the Chartered Accountants Act, 1949, a member of the Institute shall be deemed to be in practice when individually or in partnership with chartered accountant(s) in practice, he in consideration of remuneration received or to be received:

- (i) engages himself in the practice of accountancy; or
- (ii) offers to perform or performs services involving
 - auditing; or
 - verification of financial transactions, books, records; or
 - preparation, verification or certification of financial accounting statements and related statements or holds himself out to the public as an accountant;
- (iii) renders professional services or assistance in or about matters relating to accounting procedure or the recording, presentation, or certification of financial facts or data; or
- (iv) renders such other services as in the opinion of the Council may be rendered by Chartered Accountant in practice.

Regulation 190A of the Chartered Accountants Regulations, 1988, states that a chartered accountant in practice shall not engage in any business or occupation other than the profession of accountancy and such other services as may be prescribed by the Council of ICAI. In the opinion of the Council of ICAI, the "other services" that may be rendered by a chartered accountant as described in Section 2(2)(iv) will include the entire range of management consultancy services, as described below:

- (i) financial management planning and financial policy determination;
- (ii) capital structure planning;
- (iii) working capital management;
- (iv) preparation of project reports and feasibility studies;
- (v) preparing cash budgets and other budgets, cash flow statements, profitability statements etc.;

- (vi) inventory management, price fixation and other management decision making;
- (vii) personnel recruitment and selection;
- (viii) management and operational audit;
- (ix) advise regarding mergers and amalgamations;
- (x) systems analysis and computer related services;
- (xi) acting as advisor or consultant to an issue, including matters such as:
 - drafting of prospectus and memorandum containing salient features of prospectus;
 - drafting and filing of listing agreement and completing formalities with Stock Exchanges, ROC and SEBI;
 - preparation of publicity budget;
 - advice regarding selection of various agencies connected with issue such as Registrars to Issue, printers and advertising agencies;
 - advice on post issue activities;
- (xii) investment counselling in respect of securities as defined in SCRA, 1956 and other financial instruments;
- (xiii) acting as Registrar to an Issue and for transfer of shares/other securities;
- (xiv) quality audit, environment audit, energy audit;
- (xv) acting as Recovery Consultant in the Banking sector;
- (xvi) insurance financial advisory services under IRDA, 1999, including insurance brokerage.

It is to be noted that the activities of brokering, underwriting and portfolio management are not permitted.

Management Services – interpretation:

Management services vis-à-vis management consultancy services: Section 144 has used the words “managements services” while section 2(2)(iv) of the Chartered Accountants Act, 1949 read with Regulation 190A (supra) have used the words “management consultancy services”. In this regard, attention of Clause 11 of Part I of the First Schedule to the Chartered Accountants Act, 1949 to be looked into and which says that

“Clause 11: If he engages in any business or occupation other than the profession of chartered accountants, unless permitted by the Council to so engage;

Provided that nothing contained therein shall disentitle a chartered accountant from being a director of a company (Not being managing director or a whole time director), unless he or any of his partners is interested in such company as an auditor.”

Thus, it follows that the scope of section 144(h) of the Companies Act, 2013 cannot go beyond section 2(2)(iv) and Regulation 190A (supra), in light of the

provisions contained in aforementioned Clause 11 of Part I of the First Schedule to the Chartered Accountants Act, 1949.

Thus, whether a particular service falls within management service under section 144(h) of the Companies Act, 2013 and hence is restricted, should be assessed on the following considerations:

1. Whether the service is within the purview of management services read with Regulation 190A (supra);
2. Whether by rendering such a service the auditor is not performing any managerial function or not making any managerial decisions;
3. Whether the auditor is merely reviewing and reporting on the work done by the audit client or by a third-party specialist employed by the audit client because, in such a situation the “third party or the audit client is the source of the financial information subject to the review or audit” and “the auditor will not be reviewing or auditing his or her own work.

If the answers to above three considerations are in affirmative then such a service is not restricted under section 144(h) of the Companies Act, 2013.

For instance: Filing VAT/ Service Tax Returns, Filing IT/ TDS Returns, Filing ROC forms which are not to be certified by any professional, Issuing opinions on Tax, FEMA or other issues etc. are not fall under the definition of Section 144(h) of the Act.

7. Punishment and Compoundability

For contravention of provisions of this section by the Auditors, the provisions of subsection (2) of section 147 will be applicable. Further, the office of the auditor may be vacated in terms of clause (e) or (h) of sub-section (1) of section 141 in certain cases.

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