



New Dimensions of the Relationship between a Company and its Auditors – An Analysis of Union of India and ANR. Vs Deloitte Haskins and Sells LLP And ANR.

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Citation: Anmol Kaur Nayar (2023). New Dimensions of the Relationship between a Company and its Auditors – An Analysis of Union Of India and ANR. Vs Deloitte Haskins And Sells LLP And ANR., *Educational Administration: Theory and Practice*, 29(3), 1393-1397
Doi: 10.53555/kuey.v29i3.9417

Introduction

The accounts of a company are significant indicators of its performance in the market. The auditors are responsible for conducting an impartial inspection and verification of the books of accounts of a company so as to ensure that the figures indicated therein are correct. This verification is crucial for the interest of investors and the overall capital market stability. However, collusion between auditors and the management for mutual benefit is not uncommon. Many provisions of the Companies Act, 2013 come into play in such a case. One such provision is Section 140(5). This case revolves around the liability of fraudulent auditors and the powers of National Company Law Tribunal with regard to them under the said provision. Additionally, the judgment throws light upon the legislative purpose of section 140(5) and its relevance in the event of resignation by an auditor before a final order is passed under the said section.

Facts

1. The Infrastructure Leasing & Financial Services Limited (hereinafter referred to as ILFS Group) is a group of a core Indian investment company and its various direct and indirect subsidiaries responsible for its holding business in various sectors such as Transportation, Energy, Financial Services, Real Estate etc. ¹ Around June 2018, the aggregate value of debt liability of ILFS Group reached more than 91,000 Crores. This was also followed by an array of defaults by member companies till September 2018. These events led to panic selling of stocks of these companies under a threat of collapse due to the impending debts and defaults. Noticing this state of affairs, the Department of Economic Affairs, Ministry of Finance requested the Ministry of Corporate Affairs (hereinafter referred to as MCA) to take an action. In addition, in the year 2017-18, the ILFS group reported losses of Rs. 2670 Crores. It was apprehended that the quantum of debt along with presence of the group in a wide range of sectors poses a risk of hampering the capital markets and hence the economy.
2. Simultaneously, the MCA directed the Serious Fraud Investigation Officer (hereinafter “SFIO”) to investigate into the affairs of the group. On October 1, 2018, the National Company Law Tribunal (hereinafter “NCLT”) dissolved the then existing board of directors through an interim order in the Company petition No. 3638/2018 filed by MCA on the same date. The interim investigation report of SFIO, as demanded by the MCA under section 212(11) of the Companies Act, 2013 (hereinafter “the Act”) was submitted in the mean time. This report revealed the individuals who were in control of the group companies and the frauds perpetrated by them. Consequently, the MCA moved an application before the NCLT to implead the erstwhile directors of these companies in the ongoing proceedings under the company petition No. 3638/2018.
3. Another petition was filed under Section 130 of the act by MCA before the NCLT for directing re-opening of the books of account of the group. On January 1, 2019, the NCLT passed an order for re-opening the accounts of IL&FS, IFIN & ITNL for the past 5 financial years since the affairs of ILFS, IFIN & IL&FS Transportation Networks Limited (hereinafter referred to as ITNL) had been mismanaged casting a doubt on the reliability of the financial statements/accounts. 4. During this period, the BSR & Associates LLP (hereinafter referred to as BSR) and Deloitte Haskins & Sells LLP (hereinafter referred to as Deloitte) were the auditors of this group. The order on NCLT directing re-opening of books of account of ILFS group was challenged by one of the erstwhile directors of the group before the National Company Law Tribunal (hereinafter NCLAT) and upon its failure, before the Apex Court. However, the appeal was dismissed by the apex court vide order dated June 4, 2019 and the initiation of petition under section 130 was upheld.
4. A criminal complaint was filed by SFIO against, inter alia, auditors i.e. Deloitte and BSR on May 29, 2019 upon a direction of MCA under Section 212(14). On June 10, 2018, the MCA filed a company petition under

¹ <https://www.ilfsindia.com/significant-developments-post-2018.aspx>.

section 140(5) of the Act for the removal of BSR as auditors (since the auditorship of Delloite was already over by the due to efflux of time) of the group and to ban both Delloite and BSR from acting as auditors for any company for a period of five years.

5. On June 19, 2019, BSR resigned from the position of auditor. On the same day, BSR filed a reply to section 140(5) petition contending that since it had already resigned from the position of auditor of IFIN, section 140 did not apply to it. On the same day, BSR along with its engagement partners and Delloite also filed an application challenging the maintainability of section 140(5) petition on the same grounds.

6. In its decision, the NCLT upheld the maintainability of the petition. The NCLT order, along with the vires of section 140(5), was challenged before the Bombay High Court. The High Court reversed the NCLT order and quashed the petition filed under section 140(5). It also set aside the directions issued by the MCA to SFIO under section 212(14) along with criminal proceedings instituted by the SFIO pursuant to these directions.. The order of the High Court was challenged by Union of India before the Hon'ble Supreme Court in the present appeal. Since the appeal revolves around the interpretation of section 140(5), it is important to reproduce the same before analyzing the contentions of both parties.

“140. Removal, resignation of auditor and giving of special notice

(5) Without prejudice to any action under the provisions of this Act or any other law for the time being in force, the Tribunal either suo motu or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors:

Provided that if the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall within fifteen days of receipt of such application, make an order that he shall not function as an auditor and the Central Government may appoint another auditor in his place:

Provided further that an auditor, whether individual or firm, against whom final order has been passed by the Tribunal under this section shall not be eligible to be appointed as an auditor of any company for a period of five years from the date of passing of the order and the auditor shall also be liable for action under section 447.

Explanation I.—It is hereby clarified that the case of a firm, the liability shall be of the firm and that of every partner or partners who acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its director or officers. Explanation II.—For the purposes of this Chapter the word –auditor includes a firm of auditors.”

Issues

1. Whether the legislative intent of Section 140(5) is removal of auditor, either by the company, government or through resignation?
2. Whether proceeding under section 140 (5) was maintainable after resignation tendered by BSR before passing of final order by NCLT under the said section?
3. Whether the direction issued by MCA to SFIO for initiating criminal proceedings against BSR and Delloite under Section 212(14) valid?
4. Is Section 140(5) of the Companies Act, 2013 unconstitutional ?

Contentions of Parties

1. On the issue of legislative purpose of Section 140(5)

The Appellant, Union of India, urged before the apex court that the interpretation of this section by High Court was erroneous. The High court held that in case of a fraud colluded between a company and its auditors, this section comes in to break that collusion. How that collusion is broken is irrelevant for determining whether the this purpose has been fulfilled or not. Removal of auditors by the government or self initiated resignation of auditors are both sufficient achieving the purpose of this section in the opinion of the High Court. Due to this interpretation, the high court was of the opinion that once the auditors placed their resignation on record, the purpose of section 140(5) was fulfilled and there was no need to keep the petition filed by MCA under this section in pendency, hence quashing the same.

It was submitted by the appellants in regard to this point that a reading of section 140(5) along with its two provisos and explanation indicate that if an auditor of a company is acting directly or indirectly in a fraudulent manner or is abetting or colluding in fraud with the management of a company, the main body of this section empowers either the Central Government or any concerned person to approach the NCLT or alternatively, initiation of a suo motu action by it. The first proviso suggests that if the tribunal is satisfied upon the requirement of change in the auditors, it shall pass an order in this regard within fifteen days of receipt of application under the main body, authorising the Central Government to appoint another auditor in its place. It was further submitted that if an order has been passed against an auditor or a firm under the main body, it shall be ineligible to act as an auditor for any other company for the next five years and shall also be liable for an action under section 447 of the act. It must be pointed out here that Section 447 pertains to punishment for fraud. Thus, it was the submission of the appellant that even if there is an order for removal of the auditors under the main body of section 140(5), or the same has been achieved through their

resignation, the proceedings under this section can continue owing to the provisos for directions on their ineligibility to act as auditors for some other company. Therefore, the resignation by auditors does not amount to non-maintainability/quashing of section 140(5) application.

On the other hand, the respondents contended that Section 140(5) of the Act has been drafted only to motivate a colluding and fraudulent auditor into resigning. To support this contention, reliance is placed on the heading of section 140 which is "Removal and Resignation of auditors". Therefore, the correct interpretation, according to the respondents would be that if an auditor resigns after the filing of a Petition under Section 140(5), but before passing of final order by NCLT on that Petition, the purpose behind Section 140(5) of the Act is fulfilled. In addition, a strict interpretation of second proviso to section 140(5) would render the provision unconstitutional for being arbitrary, harsh and burdensome. In order to make it constitutionally valid, the period of barring the guilty auditor should be read to be "upto 5 years" instead of "5 years". It was further contended that the period of continuation of disqualification should be determined proportionally to the quantum of fraud. Lastly, the respondents submitted that said disqualification would apply only to the concerned audit partners and not to the firm as a whole, extending to other audit partners who were not connected with the fraudulent act or acts.

2. On Liability of Auditors under Section 140(5)

The respondents submitted that there the act should be interpreted in a holistic manner. Since there are specific provisions for regulating the conduct of auditors and fixing their liability, it is not right for the NCLT to proceed against the auditors under Section 140. Section 447 pertains to punishment for fraud. In addition, Section 132 constituted the National Financial Reporting Authority (hereinafter "NFRA") and empowers it to impose penalty or punishment on an auditor is found guilty of professional misconduct. Since colluding with company to manipulate accounts is amounts to professional misconduct, it shall be covered by section 132 and 447. A penalising order cannot be passed under the second proviso to section 140(5). The respondents also highlighted Section 141(3)(h) of the Act. This section disqualifies the auditor for 10 years from the date of conviction for an offence involving fraud. It was submitted that the main cause inviting penalty in both sections i.e. Section 141(3)(h) and Section 140(5), is an act of fraud by the auditors.

It was further submitted that as far as criminal liability of auditors is concerned, Section 147(3) imposes financial liability on auditors through refund or damages where the auditor is convicted under Section 147(2) of the Act. Section 147(5) further imposes civil and criminal liability jointly and severally on firm and concerned partners. Section 241(3) pertaining to oppression and mismanagement would be relevant for civil liability of auditors according to the respondents since they would fall under "any person concerned in the conduct and management of the affairs of a company". It was also submitted that Section 245(1)(g)(ii) provides for damages or compensation to be ordered against auditors in case of a false and misleading statement in audit report. Therefore, even if section 140(5) becomes inapplicable on an auditor after resigning, he would still face civil and criminal consequences under other sections as revealed above.

3. With regard to the validity of direction issued by MCA under Section 212(14) and subsequent initiation of criminal proceedings by SFIO

It was the submission of the auditors that section 212 envisages 2 kinds of reports which are to be given by the SFIO upon receiving a direction of investigation by MCA. The first is an interim report and the second is a final report. As per the respondents, the MCA could direct the SFIO to initiate criminal proceedings against them after receiving a final report. However, such direction was issued on the basis of a report of SFIO which, though a second report, was also an "interim" report and not an "investigation report" within the meaning of section 212(12) of the Act. The second contention on the point was that the 2nd interim report was running into 32000 pages and the MCA directed the SFIO to initiate criminal proceedings against BSR and Deloitte within 30 hours of receiving such report. This fact shows that the direction was issued without actually perusing the report and with non application of mind. Therefore, in the absence of any final report and non application of mind to the voluminous interim report, the direction and the proceedings arising out of it are liable to be set aside.

Decision and Analysis

The decision of the hon'ble Supreme Court along with an analysis on each point has been discussed below.

1. On the legislative intent of Section 140(5)

After analysing the legislative history of the Companies Act, 2013 along with the recommendations made by the previous Standing Committee in respect of Companies Bill, 2009, the apex court observed that the purpose of introducing section 140(5) was to make the provisions more stringent and to provide for consequences for an auditor when such auditor is found to have been perpetrating a fraud and is removed by the NCLT. Once a final order is passed by the tribunal holding that the auditors acted fraudulently under the main body of section, two consequences follow. The first consequence is that the auditor shall be removed from his position and the second consequence is that such auditor shall be barred from acting as an auditor for any other company for the next five years.

Analysis

An analysis of the judgment reveals that the Bombay High Court and the hon'ble apex court had contrasting opinion on the legislative intent of section 140(5). one one hand, the High Court held that the intent behind the section was to effectuate a change of the auditor, on the other hand, the hon'ble apex court held that the intent was to subject the auditor to stricter penalty for acting fraudulently. The problem with the interpretation given by the high court was that it was based only on incomplete consideration of the section. The intent of change of auditor can be inferred from the main body and the first proviso. However, the second proviso talks about passing of a final order and consequent bar on guilty auditor from acting in that capacity for any company. If the intent, as envisaged in the HIGH court judgment, was correct, there would be no need to add the second proviso to the section. Therefore, the Supreme Court has taken a complete view of the intent and purpose of section.

2. On maintainability/continuation of Seciton 140(5) application after resignation of auditor

Holding section 140(5) to be a substantive provision, the court held that once a final order has been passed by NCLT holding the auditors guilty of fraud in collusion with the company, the consequences mentioned under second proviso shall follow. Therefore, the view of Bombay High Court that the resignation of auditors after filing of application under section 140(5) terminates the proceeding under said section was held to be erroneous. The apex court held that the termination of proceedings under section 140(5) depend upon the final order passed by the NCLT in regard to the role of auditors in the fraud. A proceeding initiated under the said section has to reach its logical ending. If the interpretation given by the High Court is to survive, then every fraudulent auditor would escape the final order by NCLT, by resigning before such order is passed, rendering the second proviso nugatory and vitiating the very legislative intent behind the section.

Analysis

Both the High court and the Supreme Court had opposing view on his point just like the first point discussed above. It must be pointed out that the interpretation of section 140 (5) as given by High court would have given the unscrupulous auditors to escape from their liability under this section simply by resigning from their position once an application was filed against them under this section. This would enable them to bypass the procedure laid down under the said section. Not only would this make the power given to NCLT under the said section pointless, it would also dilute the stringency of the section, defeating the very purpose of it. Auditors play a very important role in building trust of investors in capital markets. They are responsible for bringing transparency in the compary-investor relationships. Therefore, a fraud committed by the auditors has far reaching consequences not just on the company, but for the capital market. A relationship between the quality of auditors and the company's performance is well established.²

3. On presence of other provisions which can possibly achieve the same result as section 140 (5)

The hon'ble court held that section 140(5) over rides other sections dealing with civil and criminal liability of auditors. This legislative intent is apparent from the words "without prejudice to any action under the provisions of this Act or any other law for the time being in force". Consequently, irrespective of the other provisions in the Act, the power of tribunal to pass an order under section 140(5) is untenable. With regard ot the contention that an auditor would face the same consequences under section 241 (3) as it would face under section 140(5), the apex court held that section 241 (3) pertains to persons who are "concerned in the conduct and management of the affairs of a company". The auditor acts as an independent examiner of accounts and cannot be said to be holding an office in the conduct and management of the company.

Analysis

In the process of deciding upon this point, the Supreme Court has also shed light on the nature of relationship between the auditor and the company. As observed by the court, the auditor is an independent examiner of accounts. The position of auditor is nto similar to the directors who have an interest in the working of the company. The auditor is an inspector of the accounts and has also been endowed with the responsibility to ensure that the accounts are maintained properly and reflected true picture. Auditor is also, inter alia, responsible for reporting any kind of discrepancy in accounts to the management and other concerned authorities.³ Since higher degree of fairness and impartiality is expected from an auditor, a fraud committed by him or her is treated as grave than that committed by other persons involved in the management and conduct of affairs of the company. This judgment has also cleared the scope of the phrase "persons involved in the conduct of affairs and management of the company". The apex court has rightly observed that section 241 pertaining to Oppression and Mismanagement does not apply to auditors since they so not fall within the phrase "persons involved in the conduct of affairs and management of the company".

² Daniel Aobdia et al., *Capital Market Consequences of Audit Partner Quality*, 90 TAR, 2143, 2176 (2015).

³ The Companies Act, 2013, No. 18, Acts of Parliament, 2013 (India) Section 143.

4. With regard to the validity of Section 212(14) direction and subsequent initiation of criminal proceedings by SFIO

The court held the direction issued by MCA under Section 212(14) to be valid. It was rightly observed that merely the fact that MCA directed the SFIO to initiate criminal proceedings against the auditors within 30 hours of receipt of report does not indicate that the direction has been issued without application of mind. This was the prime reason due to which the High Court had set aside the direction under section 212(14) since it observed that whole report could not be considered during that duration. The requirement for issuing a direction under Section 212(14) is whether there is sufficient material on record for prosecution. Of course, the auditor would be given ample opportunity to defend himself during the course of trial.

5. On the constitutionality of Section 140(5)

With regard to the contention that section 140(5) is violative of Article 14 of the Constitution of India, 1956, since it discriminates against the auditors unfairly by providing harsher treatment than that given to likely places perpetrators of fraud such as directors and management etc, the hon'ble apex court observed that the auditors are placed at a much higher pedestal than the directors since "they have to act in the larger public interest and all other stakeholders including investors etc."

With regard to the submission that Second proviso to section 140(5) is violative of fundamental right of auditors to carry on their business or profession under Article 19(1)(g), it was held that the fundamental right acts only in favour of bona fide auditors. Second proviso to Section 140(5) entails a consequence for auditors found to be fraudulent, therefore, those who violate the law by indulging into serious misconduct of fraud, cannot seek the protection of Article 19(1)(g) of the Constitution.

Analysis

It must be pointed out that the Supreme Court has developed a clear distinction between bona fide auditors and auditors found to have committed fraudulent acts. Since section 140(5) puts a ban on those auditors which have been found to be guilty of fraud, they cannot claim the protection of fundamental right to carry on business. The decision of the court is in line with the well established doctrine of Clean Hands. The doctrine states that "those seeking equity must do equity." The doctrine has been extended to all courts and judicial forums.⁴

Conclusion

This judgment has set the record straight for many questions revolving around the role of auditors in a company. It has clarified the relationship between the auditor and the company, the difference of this relationship from that of directors, the civil and criminal liability of auditors in case of a fraud. Most importantly, the judgment highlights how all the sections pertaining to auditors have to be read together resulting in far reaching consequences for the auditors acting for companies. As a consequence of this judgment, the auditors have been endowed with greater responsibility and have been subjected to much greater liability in case of a fraud. Therefore, it is going to induce the auditors to fulfill their duties while exercising greater caution, thus reducing the chances of frauds, increasing transparency in the capital markets and driving economic growth.

⁴ Ramjas Foundation and another vs. Union of India and others (2010) 14 SCC 38 (India).