Role of professionals as quasi-regulatorswith special reference to frauds & its costs

Makarand Lele
Immediate Past President ICSI & Secretary CSIA

Amogh Diwan
Practicing Company Secretary

Though business forms in general are probably as old as commerce itself and have differed violently throughout the world, the company form with broadly similar characteristics gained prominence since the 13th century. Since the first attempt of regulating the company form of organisation through the Bubbles Act, 1720 in England, the corporate legislations have come a long way. The history of their development affords some detailed insights into the rationale behind various provisions of the law and allows one to forecast with a reasonable accuracy the path it would take in response to challenges of the times. The most significant changes often coincide with the detection of a widespread abuse of provisions. Another such tipping point may have been reached now with respect the frauds being committed in and through companies. This article focuses mainly upon the possible cost-minimizing role of specialised practicing professionals like Company Secretaries, Chartered Accountants and Cost Accountants in such scenarios.

Agency costs in companies

The introduction of transferability of shares without the consent of all members under the Joint Stock Companies Act, 1844 in England and later introduction of concept of limited liability of members through Limited Liability Act, 1855 (both concepts which were later adopted in India through the procedure of legal transplant) heralded unprecedented growth in the number of companies and also paved way for diversification of ownership. Such positive development also led to the rise in the agency costs, chiefly in the form of frauds being committed on shareholders, as the divestiture of ownership and management grew. Over the course of centuries, there was a firm shift from Shareholder Primacy model to Stakeholder model where the interests of a wider class of stakeholders were recognised. Today, any company is a complex amalgam of various, and often conflicting, interests. Such complexities, coupled with the growing separation between the persons who have supplied the funds and the persons who are conducting the affairs of the company, have resulted in irreconcilable conflicts of interests.

The persons who are conducting the affairs are expected to act like the agents of the persons who supply the funds in different forms like equity and debt. However, the same is not always true. Where agent acts in his own interests rather than that of the principal, agency costs are created. The agency costs are higher in the organisations where such divestiture is most pronounced, chiefly in listed companies. As a general rule, the monitoring costs component of agency costs is higher for the more complex tasks which are delegated. Information and coordination costs are higher in case of heterogenous interests, again a case present in listed companies due to the sheer diversity of the stakeholders.

Strategies of containing agency costs

Multiple legal strategies are deployed throughout the world to reduce agency costs ranging from increasing the rights of shareholders to litigate, increasing the regulatory oversight over the company, mandating the appointment of independent persons or persons charged with the protection of the interests of the minority, reducing the information gap by better disclosures, and enforcement of compliances through sanctions. Out of the legal strategies as well, two categories could be made: regulatory strategies (sanctions which dictate the substantive parts) and governance strategies (strategies facilitating the shareholders to control their agents). While the former tries to reduce the information and coordination costs, the latter tries to reduce the divergence from the charted path. The Indian Companies Act, 2013 adopts a mix of the two. An example of the former is the prevention of direct or indirect loans to the directors or their relatives or firms where they are partners under sub-section (1) of section 185 while for the latter, various aspects which are left to be prescribed through the articles of association of the company may be quoted.

Both the strategies depend heavily upon the regulators and courts to ensure the compliance. However, the number of regulators and courts are not commensurate to the number of companies in existence. It is not practicable to routinely invoke the provisions of inspection of companies to find out the non-compliances or defaults. Hence, it is pertinent to have independent professionals to verify the compliances of the provisions of the Act.

Position of practicing professionals

The interests of the practicing professionals are not tied with the profits of the companies they consult to and hence, can act as the impartial agents with interests in proper compliance of the laws. Such professionals are in a position to act as the sentinels of corporate governance. They are a way of externalisation of control mechanism by the regulators. Such externalisation ensures that the compliance of the provisions of the Act is ensured at all times. The role assigned to professionals may broadly be categorised as certification services (with respect to various forms required to be filed or transactions to be effected) and the services to be rendered specifically by auditors.

There are four types of audits under the Companies Act, 2013: Statutory Audit of accounts, Secretarial Audits regarding legal compliances, Cost Audit of cost records, and Internal Audit. While the statutory audit is mandatory for all companies, the other three types are based upon the satisfaction of certain criteria. There are multiple provisions which prescribe duties, delineate powers and generally, take a note of the role of the auditors.

Services from auditors, in addition to their core audit scope and mandate, are required for other corporate transactions like reduction of share capital, corporate restructuring. Additionally, they have certain rights and duties like attending general meetings for facilitating answerability to the ultimate principal. They are also liable to the ultimate principal through the mechanism of class action suit.

It is apposite to take stock of a particular duty of the Statutory, Cost, and Secretarial Auditors to report the frauds in the company. The duty under section 143 of the Companies Act, 2013 read with the rule 13 of the Companies (Audit and Auditors) Rules, 2014 has been to report the ongoing as well as concluded frauds in the company which were carried on by the officers and employees of the company upon coming into their knowledge in the course of the performance of his duties as auditor. The gravity of the fraud decides the reporting procedure for the same. Such reporting must be preceded by the ascertainment of fraud. Failure to detect and report fraud exposes the professional to profoundly serious outcome of fine from INR 1 lakhs to INR 25 lakhs.

The other type services is one where the certification of a professional is required to be taken under the Companies Act, 2013. While these are limited to the specific transaction, the effect of the certification is of a similar shade to that of the Audit as they often require the professional to certify that all requirements of the Companies Act, 2013 have been complied with. These transactions range from incorporation of the company to the corporate restructuring exercises, scrutinising the voting of shareholders to the closure of the company. Another important recognition for the expertise of the professionals has been their recognition as the Mediators for corporate disputes.

Challenges and the way forward

While it may argued that the powers of the professionals under the legislation are sufficient for efficacious discharge of the duties and an enhancement of the same is not called for, the real requirement is the shift in the attitude, both of the professional as well as the corporates. Rather than treating the audits as checkboxes which are simply to be ticked off, they shall be seen as a way of minimisation of non-compliances and, for the lack of an elegant expression, 'litigation-proofing' the company.

Amongst other challenges before professionals is the specificity of legislation defining 'fraud. As the sections and definitions are often overarching, they define 'fraud' very generally. The professionals are tasked with identification of behaviour which may amount to 'fraud' in a particular scenario. Interpretational decisions are required to be made in a manner not dissimilar from the Courts in case of post regulation changes like the technological progress which necessitates active interpretation of laws.

Such multifarious decisions make the professional liable to an unintended slip. In such genuine cases, the provisions for compounding or composition shall be extended to the independent professional as well. Under the Companies Act, 2013, the present section 441 confines this option only to the delinquent company and its officers. Further, the Indian jurisprudence on the professional liability is still at a nascent stage.

To sum up, the role of the professionals under the corporate legislations may be enhanced as a solution to the problems of increasing agency costs. The professionals have proven their mettle while acting as Insolvency Professionals under the Insolvency and Bankruptcy Code, 2016. A similar success story may be scripted in other spheres provided that concerted efforts on the above lines are made.