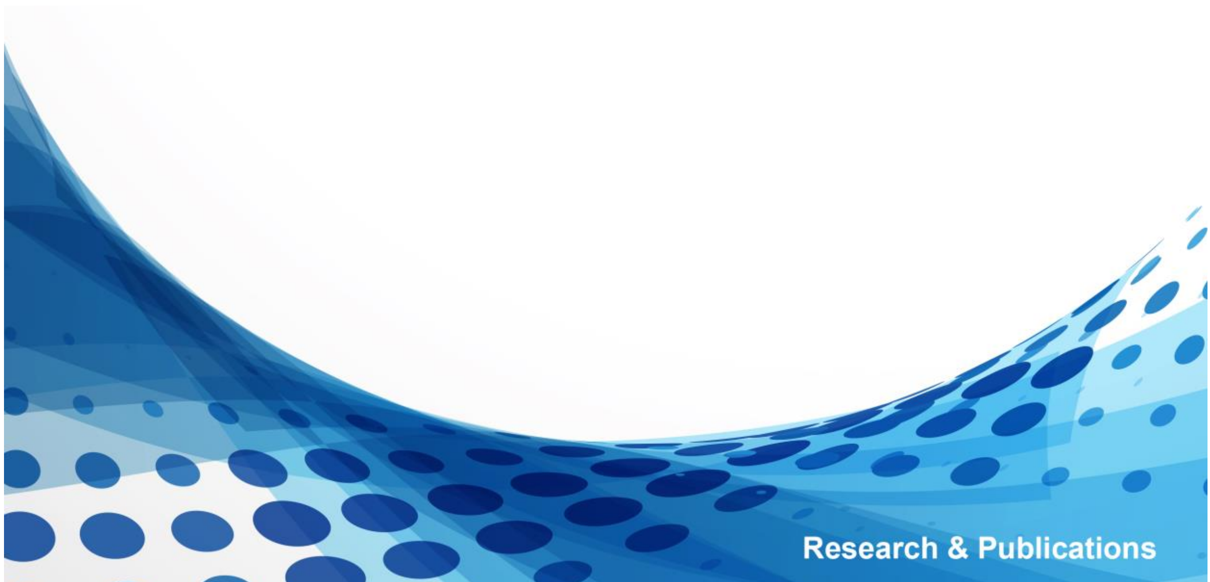
भारतीय प्रबंध संस्थान अहमदाबाद
INDIAN INSTITUTE of MANAGEMENT AHMEDABAD

IIMA
Working Paper

Disciplining Orders Under the National Financial Reporting Authority Framework: Stepping into a Strict Liability Regime

M. P. Ram Mohan
Vishakha Raj



Research &
Publications

W. P. No. 2023-05-02

Disciplining Orders Under the NFRA Framework – Stepping into a Strict Liability Regime

M.P. Ram Mohan
Vishakha Raj

May 2023

The main objective of the working paper series of the IIMA is to help faculty members, research staff and doctoral students to speedily share their research findings with professional colleagues and test their research findings at the pre-publication stage. IIMA is committed to maintain academic freedom. The opinion(s), view(s) and conclusion(s) expressed in the working paper are those of the authors and not that of IIMA.

भारतीय प्रबंध संस्थान अहमदाबाद
INDIAN INSTITUTE of MANAGEMENT AHMEDABAD

Disciplining Orders Under the National Financial Reporting Authority Framework: Stepping into a Strict Liability Regime

M P Ram Mohan* & Vishakha Raj[Ψ]

Abstract:

The National Financial Reporting Authority (NFRA) was established to fill a gap in the oversight of auditors by independent regulatory bodies. Prior to the establishment of the NFRA, only the Institute of Chartered Accountants of India (ICAI), a self-regulatory body could bar auditors from practicing in the event that they had engaged in professional misconduct. This regime began to change as auditors engaged with public firms, bringing the securities regulator into the mix as well. The decisions of ICAI and SEBI have not followed a consistent approach. A finding of misconduct is often accompanied by a finding of gross negligence and the latter does not have a uniform definition. The NFRA, being a nascent authority has only begun to issue orders against auditors over whom it has jurisdiction. Its orders are based on the same substantive law relating to professional misconduct of auditors as the ICAI, however, NFRA orders have shown more consistency in their approach and outcome. This paper examines the decisions of the NFRA from 2020 till December 2022 and posits that the consistency in its approach has been achieved by developing a no-fault regime for auditors.

Keywords: Professional misconduct, auditors, National Financial Reporting Authority, Strict Liability

---

* Professor, Indian Institute of Management Ahmedabad

Ψ Legal Researcher specialising on international investment, trade, and commercial laws.

For any comments on the paper, please reach out to <mprmohan@iima.ac.in>

I. Introduction 3
II. Statutory Framework and Demarcation of Jurisdiction 5
A. The Institute for Chartered Accountants in India 5
B. The Securities and Exchange Board of India 7
C. National Financial Reporting Authority 8
III. Examining the NFRA's approach to deciding cases of professional misconduct 11
B. NFRAs approach to disciplining professional misconduct of auditors 12
C. NFRA Orders: towards a strict liability regime 14
i) Decisions on the IL&FS Audit 14
ii) Other orders of the NFRA and indicators used to decide penalties 18
IV. Assessing the NFRA's Approach 22

I. Introduction

Agency issues occupy considerable space in discussions on corporate governance. In corporations, these agency issues are three-fold.[1] Firstly, the separation between ownership and management (shareholders and Board of Directors respectively) means that the owners have lesser knowledge about the day-to-day workings of the company and consequently its overall financial position.[2] Secondly, there is a level of information asymmetry even within the category of shareholders – majority shareholders may know more about the company's functioning than minority shareholders.[3] Third and finally, those who are members of a corporation are likely to have more information about its workings than those that engage externally with the company.

An example of this is the information asymmetry between a company and its creditors. To remedy this, company law requires that corporations disclose their financial position to their shareholders on a regular basis. For listed companies, these requirements are stricter and governed by securities laws.[4] However, the agency problem would not be solved if the management of the company was simply allowed to self-certify its financial position. Information about the financial status of a company such as its profits, losses, and debt are important considerations for its investors, shareholders, and creditors. This is why regulations relating to the stock market will often require such information to be provided to the public.[5] Accordingly, the veracity of a company's financial statements is certified by independent auditors. When stakeholders are presented with audited financial statements, they should be able to rely on them to get an accurate picture of the company's profits, losses, and indebtedness. Auditors who are negligent in the procedures they follow or who demonstrate a lack of independence can be penalised by different bodies depending on the context in which their professional misconduct has occurred. These bodies are the Securities and Exchange

[1] "Findings and Recommendations on Regulating Audit Firms and the Networks," Committee of Experts Report (Ministry of Corporate Affairs, Government of India, October 25, 2018), 18, https://www.mca.gov.in/Ministry/pdf/2018_CommitteeExperts_Report_08112018.pdf.
[2] "Findings and Recommendations on Regulating Audit Firms and the Networks," 18.
[3] "Findings and Recommendations on Regulating Audit Firms and the Networks," 18.
[4] "Securities And Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, No. SEBI/LAD-NRO/GN/2015-16/013" (2015).
[5] See "SEBI | Securities and Exchange Board of India (Listing Obligations and Disclosure Requirements) Regulations, 2015 [Last Amended on July 25, 2022]," accessed November 21, 2022, https://www.sebi.gov.in/legal/regulations/jul-2022/securities-and-exchange-board-of-india-listing-obligations-and-disclosure-requirements-regulations-2015-last-amended-on-july-25-2022-_61405.html.

Board of India (SEBI), the Institute of Chartered Accountants of India (ICAI), and the most nascent of such institutions, the National Financial Reporting Authority (NFRA).

Of the three bodies mentioned above, the NFRA was established most recently in 2018.[6] Though the Indian Companies Act 2013 constituted the NFRA almost a decade ago, the relevant section establishing and operating the NFRA was notified only in 2018.[7] The NFRA was established to provide for independent and statutorily backed oversight of auditors given the critical role they play in corporate governance. In doing so, India started to implement best practices in corporate financial reporting regulation. One example of practices that inspired legislative reform in India was the Sarbanes-Oxley Act of the United States.[8] This paper will examine the rationale behind establishing the NFRA, its mandate, and its approach to holding auditors responsible for professional misconduct. The NFRA, during 2020-2022 has decided six cases relating to professional misconduct. While there have been few new orders during 2023, this study substantially covers analysis of the orders from NFRA's first order in 2020 till December 2022, and briefly refer to two orders[9] that came in the beginning of April 2023. The six orders are:

1. Order under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Udayan Sen at 9 (July 22, 2020);
2. Order Under Section 132(4) of the Companies Act in respect of the Show Cause Notice issued to CA Rukshad Daruvala (July 23, 2020);
3. Order Under Section 132(4) of the Companies Act against Shrenik Baid (July 28, 2020);
4. Order Under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Gulshan Jham (May 21, 2022);
5. Order Under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Som Prakash Aggarwal (ICAI Membership No. 74813) (September 12, 2022);
6. Order under Section 132(4) of the Companies Act with respect to Show Cause Notice Issued to CA Rajiv Bengali (September 19, 2022);

Before examining the NFRA in detail, Part II gives a brief overview of the state of play prior to 2018. This background is important in understanding the role of the NFRA in the regulatory

[6] "Findings and Recommendations on Regulating Audit Firms and the Networks," 12.
[7] "Findings and Recommendations on Regulating Audit Firms and the Networks," 12.
[8] "Findings and Recommendations on Regulating Audit Firms and the Networks," 43–44.
[9] Order in the matter of CA Lavitha Shetty, under Section 132(4) of the Companies Act 2013. (NFRA April 13, 2023); Order in the matter of M/s ASRMP & Co., CA A. S. Sundaresha, CA Madhusudan U A, and CA Pranaav G. Ambekar, under Section 132(4) of the Companies Act 2013. (NFRA April 12, 2023).

architecture that governs the conduct of auditors, as SEBI and the ICAI also participate in it. Part II further outlines the statutory framework that empowers regulators to discipline auditors. Each of the regulators/institutes described below draws this mandate from a different source and serves a different prerogative. For instance, SEBI's focus is the protection of investors, whereas the ICAI has a broader mandate to discipline the conduct of auditors notwithstanding who has been affected by it. Thereafter, the Part III focuses on the NFRA's decisions on auditors' professional negligence and misconduct. The discussion on the decisions of the NFRA focuses on whether there has been consistency in the parameters employed by the NFRA and how its approach compares to those taken by High Courts and the Securities and Exchange Board of India.

II. Statutory Framework and Demarcation of Jurisdiction

A. The Institute for Chartered Accountants in India

The ICAI is a self-regulatory body constituted by the Chartered Accountants Act of 1949.[10] The ICAI maintains a register of members and those who are in this register have the title of "Chartered Accountant" (CA).[11] One of the penalties that the ICAI may impose on CAs is to remove their name from the register permanently or for a period determined by the disciplinary committee of the ICAI. The Chartered Accountants Act of 1949 constitutes the ICAI and describes activities that amount to professional misconduct. Disciplinary committees of the ICAI rely on the Second Schedule of Chartered Accounts Act to evaluate an auditor's conduct. This Schedule enumerates instances in which a chartered accountant can be found guilty of professional misconduct through the course of their practice. These include breaches of confidentiality and failure to report material information that is relevant to a financial statement and known to the auditor. Clause 7 of the Second Schedule states that an auditor is guilty of professional misconduct if they are found to have committed "gross negligence" or not exercised "due diligence." The latter phrase was added to Clause 7 through an amendment to the Chartered Accountants Act in 2006. Actions carried out with due diligence are those which demonstrate a level of prudence that can be reasonably expected from a person in the relevant

[10] "The Chartered Accountants Act," Pub. L. No. 38 (1949).
[11] The Chartered Accountants Act, sec. 2(b), 2(c).

circumstances. Gross negligence, however, implies a more serious lapse in professional judgement.

The concept of gross negligence has been adapted in professional negligence cases depending on the profession involved.[12] For instance, in the context of advocates, gross negligence refers to an act of negligence (breach of duty of care) and an element of moral turpitude on the part of the advocate or disregard for the client's interests.[13] For medical practitioners, gross negligence is established when there recklessness or deliberate wrong doing accompanies a negligent act.[14] Reference to the application of gross negligence in other professions is relevant in the context of auditors because adjudicators often refer to decisions in multiple professional contexts to discern the meaning of professional negligence. The SEBI Appellate Tribunal, for instance, referred to a leading case in the field of medical negligence when deciding on whether the auditors of Satyam Computers had acted with gross negligence.[15]

Decisions of ICAI disciplinary committees had to be approved by the High Court having jurisdiction before 2006. After the 2006 amendment to the Chartered Accountants Act, disciplinary committees were empowered to decide cases brought before them and impose a penalty on an auditor without the approval of the High Court. Nonetheless, some of these decisions were appealed before High Courts, resulting in decisions that upheld or overruled the Disciplinary Committees. The decisions of High Courts between 2009 – 2019 do not demonstrate a wholly consistent approach to ascertaining whether a lapse during the audit process is an instance of gross negligence (and consequently professional misconduct under Clause 7 of the Second Schedule of the Chartered Accountants Act).[16] High Court decisions took different positions on whether *mens rea* or a mental element of intention was required for gross negligence to be established. As far as the duty of care owed by auditors is concerned, adjudicators can refer to the standards of auditing which details the steps auditors ought to take when verifying information and serves as a guide to performing at audit. In some cases, High Courts took the position that auditors who do not follow the SAs but demonstrate no recklessness or *mens rea* cannot be held guilty of gross negligence.[17] In another set of cases

[12] M. P. Ram Mohan and Vishakha Raj, "Auditors' Negligence and Professional Misconduct in India: A Struggle for a Consistent Legal Standard," *Columbia Journal of Asian Law* 34, no. 2 (May 9, 2021): 96, https://doi.org/10.52214/cjal.v34i2.8261.
[13] Mohan and Raj, 96.
[14] Mohan and Raj, 104. See, Dr. Suresh Gupta v. Govt. of NCT & Anr., (2004) 6 SCC 422, at paras 24–26.
[15] Mohan and Raj, 120-121.
[16] Mohan and Raj, 114.
[17] Mohan and Raj, 108–9.

High Courts have found that gross negligence had occurred even in the absence of *mens rea* but did not agree with Disciplinary Committee's recommendations to bar auditors from practicing for varying periods of time.[18] Finally, there were also cases in which a finding of gross negligence was made in the absence of *mens rea* and the auditor involved was barred from practicing based on the recommendation of the Disciplinary Committee.[19] These cases represent a more recent trend where the approach to disciplining auditors became strict and significantly reduced the margin of error with which auditors operated.[20]

B. The Securities and Exchange Board of India

The Securities and Exchange Board of India (SEBI) had interpreted the SEBI Act in a way that gives it the power to bar auditors from practicing in connection with the securities market (for instance, by auditing companies listed in the stock exchange). Sections 11 and 11B of the SEBI Act give SEBI the power to take action for the protection of investors. Section 12A of the SEBI Act prohibits the use of any scheme to defraud investors. Thus, if an auditor has connived to defraud investors, SEBI has held that it has the power to bar them from practicing in connection with listed companies.[21] However, during the appellate stage of the proceedings in which this interpretation was rendered, the SEBI Appellate Tribunal (SAT) reversed this interpretation of the powers given to SEBI under Sections 11 and 11B of the SEBI Act. The SAT decision closely relied on a judgement of the Bombay High Court made in relation to the same case. The Bombay High Court held that SEBI had the power to restrain auditors from practicing in relation to the securities market but only where it can be shown that they acted with an intention to defraud investors. The SAT found that no such *mens rea* existed in the present case and struck down the portion of the SEBI order which barred the auditors in the case from practicing.[22] The Bombay High Court decision and SAT decision, strike a balance between the mandate of the ICAI and SEBI by holding that the former was in charge of disciplining auditors, but SEBI would be able to take actions to protect investors.

A corollary to this demarcation of jurisdiction between SEBI and ICAI is that the mere omission to perform a duty is not the basis on which SEBI bars auditors from practicing, it

[18] Mohan and Raj, 108–9.
[19] Mohan and Raj, 110–14.
[20] Mohan and Raj, 126.
[21] Mohan and Raj, 117 See, SEBI Order under sections 11(1), 11(4) and 11B of the SEBI Act, 2017, WTM/GM/DRA 8 (India).
[22] Mohan and Raj, 119–20 See, Price Waterhouse & Co. v. SEBI, Appeal No. 6, (2018) SEBI/SAT (India), paras 52-53.

would have to be shown that they had connived to defraud investors under Section 12A of the SEBI Act.[23] At present, the Supreme Court is hearing an appeal against the decision of the SAT and has stayed the portion of its order which held that SEBI lacks the jurisdiction to bar auditors from practicing.[24] It would thus be prudent to state that ICAI has a broader jurisdiction to discipline auditors but SEBI continues to be able to restrain them from practicing in connection with the securities market if their conduct triggers sections 11, 11B and 12 of the SEBI Act.[25]

C. National Financial Reporting Authority

As mentioned in the beginning of this paper, the provisions of the Companies Act 2013 constituting the National Financial Reporting Authority (NFRA) and establishing its mandate were notified and brought into force only in 2018. The ICAI had reservations towards the NFRA's coming into force, however, the regime under which it functioned was inadequate to check the professional misconduct of auditors. The fraud that ensured in Satyam Computers was emblematic of these limitations.[26] Under the Chartered Accountants Act, the monetary penalty that may be imposed on individual auditors is capped at INR 500,000 and there is no provision for imposing a penalty on audit firms.[27] The auditors were made to disgorge the fees they had received (INR 130,901,664), however, this order was passed by SEBI and upheld by the SEBI Appellate Tribunal (SAT).[28] The jurisdiction of SEBI over the conduct of auditors and audit firms is related to their involvement in defrauding investors and thus narrower than that of the ICAI. The NFRA has more flexibility when it comes to imposing a penalty on auditors and audit firms and it has a broader mandate than SEBI.[29] NFRA thus addresses the hurdles that SEBI and ICAI each face in regulating the conduct of auditors.

[23] "Securities and Exchange Board of India Act" (1992), sec. 12A.
[24] PTI, "Supreme Court Extends Interim Stay On Appellate Tribunal's Observation On SEBI's Power To Bar Auditors," BQ Prime, accessed November 21, 2022, https://www.bqprime.com/law-and-policy/sc-extends-interim-stay-on-sat-s-observation-on-sebi-s-power-to-bar-auditors.
[25] Securities and Exchange Board of India Act, secs. 11, 11B, 12.
[26] "Findings and Recommendations on Regulating Audit Firms and the Networks," 43.
[27] See "Findings and Recommendations on Regulating Audit Firms and the Networks," 43.
[28] "Findings and Recommendations on Regulating Audit Firms and the Networks," 43 See, Price Waterhouse & Co. v. SEBI, Appeal No. 6, (2018) SEBI/SAT (India), paras 136-139.
[29] "Companies Act," Pub. L. No. 18 (2013), sec. 132(4), https://www.mca.gov.in/Ministry/pdf/CompaniesAct2013.pdf.

The NFRA has jurisdiction to enforce compliance with auditing and accounting standards with respect to the entities listed in the NFRA Rules.[30] The entities mentioned in the NFRA Rules are as follows.

a. companies whose securities are listed on any stock exchange in India or outside India;
b. unlisted public companies having paid-up capital of not less than rupees five hundred crores or having annual turnover of not less than rupees one thousand crores or having, in aggregate, outstanding loans, debentures and deposits of not less than rupees five hundred crores as on the 31st March of immediately preceding financial year;
c. insurance companies, banking companies, companies engaged in the generation or supply of electricity, companies governed by any special Act for the time being in force
d. any body corporate or company or person, or any class of bodies corporate or companies or persons, on a reference made to the Authority by the Central Government in public interest; and
e. a body corporate incorporated or registered outside India, which is a subsidiary or associate company of any company or body corporate incorporated or registered in India as referred to in clauses (a) to (d), if the income or networth of such subsidiary or associate company exceeds twenty per cent. of the consolidated income or consolidated networth of such company or the body corporate, as the case may be, referred to in clauses (a) to (d).[31]

Though there may appear to be an apparent conflict between the jurisdiction of SEBI and NFRA in the context of listed companies, the SAT has, in previous orders, exercised caution when it comes to barring auditors from practicing. The subject of SEBI's inquiry is whether fraud against investors under Section 12A of the Securities and Exchange Board of India Act 1992 (SEBI Act).[32] The issue of whether SEBI has the power to bar auditors from practicing in relation to the securities market is currently sub-judice and being decided by the Supreme Court of India. Be that as it may, the nature of conduct regulated by NFRA and SEBI in relation to listed companies is different. SEBI draws its jurisdiction from violations that fall under Section 12A.

---

[30] "National Financial Reporting Authority Rules," Pub. L. No. G.S.R. 1111(E) (2018), r. 3, https://nfra.gov.in/sites/default/files/NFRARules2018_13112018.pdf.
[31] National Financial Reporting Authority Rules, r. 3.
[32] Securities and Exchange Board of India Act, sec. 12A.

12A. No person shall directly or indirectly

(a) use or employ, in connection with the issue, purchase or sale of any securities listed or proposed to be listed on a recognized stock exchange, any manipulative or deceptive device or contrivance in contravention of the provisions of this Act or the rules or the regulations made thereunder;
(b) employ any device, scheme or artifice to defraud in connection with issue or dealing in securities which are listed or proposed to be listed on a recognised stock exchange;
(c) engage in any act, practice, course of business which operates or would operate as fraud or deceit upon any person, in connection with the issue, dealing in securities which are listed or proposed to be listed on a recognised stock exchange, in contravention of the provisions of this Act or the rules or the regulations made thereunder; (emphasis added)

The NFRA may scrutinise the conduct of an auditor and pass an order against them for professional negligence, notwithstanding whether this amounted to fraud. Section 132(4) of the Companies Act defines professional misconduct by reference to Section 22 of the Chartered Accountants Act.[33]

132. Constitution of Natural Financial Reporting Authority.— (1) The Central Government may, by notification, constitute a National Financial Reporting Authority to provide for matters relating to accounting and auditing standards under this Act.

[...]

(4) Notwithstanding anything contained in any other law for the time being in force, the National Financial Reporting Authority shall(a) have the power to investigate, either suo motu or on a reference made to it by the Central Government, for such class of bodies corporate or persons, in such manner as may be prescribed into the matters of professional or other misconduct committed by any member or firm of chartered accountants, registered under the Chartered Accountants Act, 1949 (38 of 1949):

Provided that no other institute or body shall initiate or continue any proceedings in such matters of misconduct where the National Financial Reporting Authority has initiated an investigation under this section;

[...]

Explanation.—For the purposes of this sub-section, ***the expression "professional or other misconduct" shall have the same meaning assigned to it under section 22 of the Chartered Accountants Act, 1949 (38 of 1949).*** (emphasis added)

[33] Companies Act, sec. 132(4).

This means that the NFRA would turn to the meaning given to professional misconduct under Schedules I and II of the Chartered Accountants Act in order to determine whether an auditor is guilty of the charges against them and the penalty.[34]

III. Examining the NFRA's approach to deciding cases of professional misconduct

The NFRA is required to apply multiple standards and laws in order to determine whether the conduct of an auditor amounts to professional misconduct. One of these sources is the Chartered Accountants Act, the relevant provisions of which have been discussed above. In addition to the Schedules of this Act, the NFRA also needs to take into account auditing standards prescribed by the ICAI.

A. Legal status of Standards of Auditing

Before 2014, Standards of Auditing (SA) were relevant because they prescribed the methodology of conducting an audit and were issued by the Central Government pursuant to Section 133 of the Companies Act. However, a deviation from these standards did not automatically amount to gross negligence or professional misconduct. This position did change in the case of *Mukesh Gang*[35] where the High Court of Andhra Pradesh held that an auditor could be guilty of gross negligence if they did not perform a statutory duty notwithstanding the intention accompanying such lapse.[36] In this case, the auditors certification of cheques proving the promoters' purchase of shares in a company proved to be incorrect because some of the cheques had bounced. The auditors admitted that his report could have qualified the certification of cheques (which was his statutory duty) subject to them being cleared. The High Court was of the opinion that verification was improperly conducted but guidance regarding how it may have been properly conducted was lacking. This decision drastically reduced the degree of errors that an auditor could commit before being found guilty of professional negligence. After 2014, auditing standards have been given a statutory status.[37] Sub-section (9) of the Section 143 of the Companies Act requires auditors to comply with auditing standards.[38]

---

[34] Companies Act, sec. 132(4).
[35] ICAI v. Mukesh Gang, Indlaw HYD 585 (Westlaw) (2016).
[36] ICAI v. Mukesh Gang, Indlaw HYD 585 (Westlaw) paragraphs 54, 80; See Mohan and Raj, "Auditors' Negligence and Professional Misconduct in India," 113.
[37] Order under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Udayan Sen, accessed November 23, 2022.
[38] Companies Act, sec. 143(9).

The substantive law that governs whether professional misconduct has occurred continues to be the Chartered Accountants Act, specifically Schedules I and II under the Act.[39] With the Central Government giving statutory force to the Standards of Auditing, these SAs now have the force of law.[40] In all eight decisions, the NFRA held that the statutory nature of SAs means that the existence or lack of intention is immaterial when it comes to making a finding of professional misconduct and gross negligence.[41] A lapse in following the SAs, especially those that are mandatory in nature (for instance, ones that employ language using "shall"), will result in a finding of professional misconduct, violation of a statutory duty, and gross negligence. It thus appears that there is a "strict liability" regime that has come into place after the NFRA has begun to function. While such an approach would result in consistency, it risks eroding the distinction between a lack of due diligence and gross negligence. Clause 7 of Schedule II of the Chartered Accountants Act states that both of these factors can separately be the basis of a finding of professional misconduct. In its order regarding the engagement partner of IL & FS (discussed in detail below), the NFRA emphasised the statutory force that has now been given to the SAs.[42] Accordingly, it held that entries in Schedule II of the Chartered Accountants Act will have to be read in accordance with this development and in the context of the NFRAs mandate of scrutinising auditors of PIEs. The NFRA found that not adhering to SAs would demonstrate both a lack of due diligence and "culpable negligence" or gross negligence. In arriving at this conclusion the NFRA referenced *Mukesh Gang* in addition to the new statutory framework of the NFRA.[43]

B. NFRAs approach to disciplining professional misconduct of auditors

The overarching approach of the NFRA appears to be one that examines the conduct of auditors against relevant SAs in a strict manner. The statutory nature of these SAs through their reference in the Companies Act 2013 has been used by the NFRA to take a liability approach.

[39] Companies Act, sec. 132(4).
[40] Companies Act, sec. 143(9), 133.
[41] Order under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Udayan Sen at 9; Order under Section 132(4) of the Companies Act with respect to Show Cause Notice Issued to CA Rajiv Bengali (September 19, 2022); Order Under Section 132(4) of the Companies Act in respect of the Show Cause Notice issued to CA Rukshad Daruvala (July 23, 2020); Order Under Section 132(4) of the Companies Act in repsect of Show Cause Notice Issued to CA Gulshan Jham (n.d.); Order Under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Som Prakash Aggarwal (ICAI Membership No. 74813) (n.d.); Order Under Section 132(4) of hte Companies Act against Shrenik Baid (n.d.).
[42] Order under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Udayan Sen at 9.
[43] Order under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Udayan Sen paragraphs 56–57.

Intention or evidence of deliberate action is not the focal point when assessing whether gross negligence and professional misconduct have been committed. Non-compliance with an auditing standard almost automatically invites this conclusion. For instance, in the April 2023 order against M/s ASRMP & Co., CA A. S. Sundaresha, CA Madhusudan U A, and CA Pranaav G. Ambekar, the auditors argued that non-compliance with SAs cannot be material in deciding an allegation of professional misconduct.[44] The NFRA disagreed with this contention and found that Section 143(9)-(10) of the Companies Act 2013 gave a clear mandate to adhere to auditing standards.[45]

The expectation is that auditors exercise the professional scepticism and thoroughly verify statements made by the management of a company as explanations for their balance sheet. In its order against CA Lavitha Shetty, the NFRA noted the auditor was aware of a mismatch in short term payables and receivables of the company involved in the audit.[46] The director of the company had assured the auditor that this was a short term liquidity crunch and provided a net worth certificate of one of its largest debtor. This certificate however, did not indicate a net worth that covered the full amount loaned. The NFRA faulted the auditor for relying on this certificate and the statement of the director of the company when assessing the recoverability of the company's loans.[47] The NFRA held that the auditor had not followed paragraph 8 of SA 500 when she did not evaluate the capacity and competencies of the firm that issued a net worth certificate. Auditors are thus required to strictly comply with SAs, violation of these would invite strict publishment and penalty.

A review of the NFRA orders seems to suggest the use of certain indicators to determine the penalty which needs to be imposed on the auditor. This is a step in the right direction as it explains the basis on which the NFRA exercises its discretion when imposing a penalty. However, these indicators have not been explicitly discussed in all NFRA orders.[48] The

[44] Order in the matter of M/s ASRMP & Co., CA A. S. Sundaresha, CA Madhusudan U A, and CA Pranaav G. Ambekar, under Section 132(4) of the Companies Act 2013. (NFRA April 12, 2023).
[45] Order in the matter of M/s ASRMP & Co., CA A. S. Sundaresha, CA Madhusudan U A, and CA Pranaav G. Ambekar, under Section 132(4) of the Companies Act 2013, paragraph 18.
[46] Order in the matter of CA Lavitha Shetty, under Section 132(4) of the Companies Act 2013. (NFRA April 13, 2023).
[47] Order in the matter of CA Lavitha Shetty, under Section 132(4) of the Companies Act 2013. (NFRA April 13, 2023).
[48] See, e.g. Order in the matter of CA Lavitha Shetty, under Section 132(4) of the Companies Act 2013.; Order in the matter of M/s ASRMP & Co., CA A. S. Sundaresha, CA Madhusudan U A, and CA Pranaav G. Ambekar, under Section 132(4) of the Companies Act 2013.

NFRA's approach to deciding the penalty to be imposed on auditors has been discussed using the six orders issued by it till December 2022.

C. NFRA Orders: towards a strict liability regime

i) Decisions on the IL&FS Audit

The NFRA is a nascent authority. Out of the 6 orders against auditors during the period up to 2022, three of these orders relate to the audit of the India Leasing & Financial Services Group (IL&FS) for the financial year 2017-18. Of the three orders, two deal with the company's statutory auditors from Deloitte Haskins – CA Udayan Sen (Engagement Partner) and CA Shrenik Baid (Additional Partner).[49] The third order in the IL & FS cases was against the Engagement Quality Control Review (EQCR) Partner of the IL & FS Audit – CA Rukshad Daruvala.[50] All three of these orders have been appealed before the National Company Law Appellate Tribunal and the appeals are yet to be decided.[51]

These were the first three cases decided by the NFRA and are used to provide an exposition of the legal standards applicable to auditors who may fall within the jurisdiction of the NFRA. The charges and decisions against the Engagement Partner and Review Partner are similar, and the approach taken in the decisions is consistent. Accordingly, this paper will focus on the case against CA Udayan Sen who was the Engagement Partner and was given the most severe penalty of the three IL & FS decisions.

The allegations against the engagement partner of IL & FS were*, inter alia*

i. Failure to discharge his duty to inform those charged with the governance of the company about regulatory non-compliance by the company. This duty is contained under SA 250.[52]

---

[49] Order Under Section 132(4) of hte Companies Act against Shrenik Baid; NFRA Order No. NF23/46/2021 (December 9, 2022).

[50] Order Under Section 132(4) of the Companies Act in respect of the Show Cause Notice issued to CA Rukshad Daruvala.

[51] "Company Law (AT) No. 150/2020, 151/2020,152/2020," March 16, 2021, https://nclat.nic.in/sites/default/files/migration/upload/9822579376051d8ebeefe5.pdf.

[52] "SA 250 - Consideration of Laws and Regulations in an Audit of Financial Statements" (ICAI), 7–8, accessed April 8, 2023, http://kb.icai.org/pdfs/PDFFile5b3b4e2b880640.44200490.pdf.

ii. Failure to communicate significant conditions affecting the business of the company to persons charged with its governance (this phrase refers to the management of the company, for instance, the Board of Directors).

One instance of non-compliance identified under point (i) above was in relation to the Reserve Bank of India's (RBI) Net Owned Fund (NOF) requirements. The RBI required the company, being a non-banking financial company (NBFC) to have NOF worth at least INR 2 crores. When the RBI recomputed the IFIN's NOF, it was found that the company's funds were at a net deficit of INR 4123.76 crores. The company was also not complying with this Capital to Risk (Weighted) Assets Ratio (CRAR).[53] Having not provided evidence that the engagement partner had informed the persons charged with governance about this regulatory non-compliance, the NFRA found that the auditor had acted without due diligence and was grossly negligent under Clause 7 of Schedule II of the Chartered Accountants Act.[54]

The engagement partner's defence for this charge was two-fold. Firstly, he stated that in his judgement, there was no need to inform those concerned with governance of the non-compliance. This is because they were already aware of it given the RBI communication to the company about the non-compliance. Additionally, the minutes of the meetings of the Board of Directors revealed that they were aware of the non-compliance.[55] The NFRA was not persuaded by this line of defence. The mandatory requirement under SA 250 to communicate non-compliance to the company's management was emphasised and the NFRA found that this requirement (and consequently, the SA) was violated.[56] The NFRA also pointed out that the minutes itself could not be the basis of the auditors conclusion that the persons concerned with governance were made aware of regulatory non-compliance. On this issue, the NFRA was concerned that there was no evidence of the auditor having verified the minutes. Notwithstanding the lack of verification of the minutes, the NFRA maintained that the obligation to inform persons concerned with governance on the part of the statutory auditor (under SA 250) does not seize to exist just because this information may have been conveyed by some other means. This is a rather strict and literal application of SA 250 and this approach

[53] Order under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Udayan Sen paragraph 101.
[54] Order under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Udayan Sen paragraph 110.
[55] Order under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Udayan Sen paragraphs 105, 110.
[56] Order under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Udayan Sen paragraphs 105, 110.

seems to reinforce the strict liability of auditors who deviate from SAs. An important question with regards to this charge is whether the NFRA would defer to the professional judgement of the auditor had it been recorded in the audit file. At present, the main issue identified by the NFRA to the approach of the auditor does not seem to be that the minutes were not verified.[57] Rather, that the auditor took it upon himself to decide whether it was necessary to inform persons concerned with governance about regulatory non-compliance rather than strictly adhere to the relevant SA.

The engagement partner also pointed to paragraph 23 of SA 250 which states that regulatory non-compliance that is believed to be intentional and material must be communicated to persons charged with governance. The auditor once again adopted a line of defence which stated that the SA had been complied with because the auditor had made a reasoned judgement that there was no intentional regulatory non-compliance. The RBI had provided the company time to comply with modified CRAR and NOF requirements and this, to the engagement partner, was evidence that there was no material or intentional regulatory non-compliance.[58] The NFRA was not persuaded by this line of defence either. They noted that the audit file contained no evidence of a reasoned decision being made with regards to whether the non-compliance was intentional and material. Based on the discussion as summarised above, the NFRA upheld the charge against the engagement partner that he had not fulfilled his duty to appraise the management of regulatory non-compliance and thus acted with gross negligence and without due diligence.[59]

The charges against Shrenik Baid who was the additional partner to the audit were similar to the ones levied against the engagement partner.[60] The charges included non-disclosure of material statements known to the auditor, not performing the audit with due diligence, gross negligence, and failure to invite attention to departures from generally accepted audit practices. The conduct of the additional partner was also judged against the SAs. For instance, the additional partner was also charged with not informing those charged with governance about regulatory non-compliance. The defence employed by the additional partner was similar to that

[57] Order under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Udayan Sen paragraphs 105–110.
[58] Order under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Udayan Sen paragraph 114.
[59] Order under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Udayan Sen paragraphs 102, 109, 110.
[60] Order Under Section 132(4) of hte Companies Act against Shrenik Baid.

of the engagement partner – that the auditor believed that the management was informed of the regulatory non-compliance. The NFRA was not convinced by this defence for the reasons mentioned above in the order against the engagement partner. Thus, a finding of gross negligence was made with respect to Shrenik Baid as well.[61]

The order against Rukshad Daruvala completes the list of NFRA orders relating to the audit of IL & FS. CA Rukshad Daruvala was the Engagement and Quality Control Review (EQCR) Partner for the statutory audit of IL&FS in the financial year 2017-2018.[62] EQCR is a process of reviewing the judgements made in the audit report in an objective and independent manner.[63] One of the charges against the EQCR Partner was that he did not keep a file that was separate from that of the Audit File used by the statutory auditors (Delloite Haskins and Sells or DHS) of IL&FS. Specific allegations in charges continued to take issue with a lack of documented challenges to the judgements made by the auditors of IL&FS, thus demonstrating a lack of independent review by the EQCR Partner. This, in turn, contravened SA 220[64] which casts a duty on the EQCR Partner to review working papers based on which significant decisions were made by the engagement team (of which CA Udayan Sen was the engagement partner and CA Shrenik Baid was the additional partner); perform an objective evaluation of the judgements made during the audit by the engagement team; and determine whether the Audit Report issued with respect to the auditee is appropriate. The NFRA found that the ECQR Partner had failed to carry out these duties.[65] Further charges against the EQCR partner were closely linked to the charges against the engagement partner and the additional partner.[66]

It may be recalled that one of the allegations against the engagement and additional partners was the failure to inform those concerned with the governance of the company about its regulatory non-compliance. The EQCR partner defended these charges by stating that in his judgement, he had found the conclusions of the engagement partner and engagement team

[61] Order Under Section 132(4) of hte Companies Act against Shrenik Baid paragraph 186.
[62] Order Under Section 132(4) of the Companies Act in respect of the Show Cause Notice issued to CA Rukshad Daruvala.
[63] Order Under Section 132(4) of the Companies Act in respect of the Show Cause Notice issued to CA Rukshad Daruvala paragraphs 71–72.
[64] "SA 220* Quality Control for an Audit of Financial Statements (Effective for All Audits Relating to Accounting Periods Beginning on or after April 1, 2010)," accessed January 13, 2023, https://kb.icai.org/pdfs/PDFFile5b3b4c2a41d107.18791569.pdf.
[65] Order Under Section 132(4) of the Companies Act in respect of the Show Cause Notice issued to CA Rukshad Daruvala paragraphs 68, 73.
[66] Order Under Section 132(4) of the Companies Act in respect of the Show Cause Notice issued to CA Rukshad Daruvala paragraph 78.

appropriate. For this reason, the EQCR partner had concluded that the duty to inform those charged with governance about regulatory non-compliance was adequately discharged by the auditors. The NFRA did not consider this an adequate discharge of the EQCR partner's functions. The lack of any challenge to the engagement team's behaviour was used to hold that the EQCR partner had failed to review the work of the engagement team with due diligence and committed gross negligence.

ii) Other orders of the NFRA and indicators used to decide penalties

The remaining three orders of the NFRA given during the period between 2020 and 2022 dealt with charges of failure to disclose material facts known to the auditors; failure to report a material misstatement known to the auditor, failure to exercise due diligence and acting with gross negligence in the conduct of the audit; and failure to invite any material departure from accepted audit practices; and failure to obtain information that is sufficient to form an opinion.[67]

The facts of each of the three remaining cases were different, but the NFRA continued to test the auditors conduct against the duties cast upon them by the standards of auditing. For instance, in one of the cases,[68] the CA had failed to verify the company's profits and issued at audit report that approved the company's inflated profits. This misrepresented the financial situation of the company. The auditor stressed that these lapses were not intentional. However, the NFRA held that a lack of intention to violate an auditing standard does not absolve the auditor. In this instance, SA 200 which requires auditors to question the reliability of documents and responses received from the management and those charged with governance.

In each of the six orders of the NFRA that have been issued till 2022, there have been monetary sanctions imposed along with a bar on practicing for varying periods of time. The Companies Act 2013 demonstrates the seriousness with which it views the role of auditors in PIEs. Section 132(4) of the Companies Act prescribes a minimum monetary penalty (INR 100,000 in for individuals and INR 1,000,000 for a firm) and a minimum period debarment (six months) for auditors who have been found guilty of professional misconduct. The NFRA has attributed this

---

[67] Order Under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Som Prakash Aggarwal (ICAI Membership No. 74813); Order Under Section 132(4) of the Companies Act in repsect of Show Cause Notice Issued to CA Gulshan Jham; Order under Section 132(4) of the Companies Act with respect to Show Cause Notice Issued to CA Rajiv Bengali.

[68] Order Under Section 132(4) of the Companies Act in repsect of Show Cause Notice Issued to CA Gulshan Jham.

position of the law to the importance of an auditors role and the level of trust placed in their certification.

In the IL&FS cases, the NFRA identified and examined five factors to decide the penalty for each auditor.[69] They are:

1. Loss of independence of auditors
2. compliance with the SAs
3. maintenance of investor confidence
4. reckless behaviour, and,
5. deter auditors from "going along" with fraudulent practices of the company's management

One example of loss of independence of services is when Delloite Haskins and Sells had provided IL&FS with non-audit services (management services) thus creating a conflict of interest. When the auditors were a part of the engagement team, the fact that they were senior officials in their audit firm and had participated [70](and in one instance, even led) consultancy projects of the audit firm for IL&FS weighed against them.[71] The examination of independence requirements is mandated under SA 200. Given their experience in the profession, the NFRA found that they should should have alerted them to such a breach of independence requirements. The EQCR partner was unable to flag this loss of independence when reviewing the audit, and this was taken into consideration for his penalty.[72] The EQCR partner defended his actions for stating that his role was limited to reviewing the engagement team's evaluation of the audit firm's independence. He also mentioned that he was not informed of any breaches of independence.[73] The NFRA did not comment on this contention in particular but based its

---

[69] Order Under Section 132(4) of hte Companies Act against Shrenik Baid paragraph 203; Order Under Section 132(4) of the Companies Act in respect of the Show Cause Notice issued to CA Rukshad Daruvala paragraph 137; Order under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Udayan Sen paragraph 204.
[70] Order under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Udayan Sen paragraphs 79, 81.
[71] Order Under Section 132(4) of hte Companies Act against Shrenik Baid paragraphs 67, 83, 85.
[72] Order Under Section 132(4) of the Companies Act in respect of the Show Cause Notice issued to CA Rukshad Daruvala paragraphs 85–87.
[73] Order Under Section 132(4) of the Companies Act in respect of the Show Cause Notice issued to CA Rukshad Daruvala paragraph 78.

finding on a loss of independence of the audit firm on the lack of documentation regarding how the EQCR had challenged the findings of the engagement team.[74]

The second factor refers to compliance with the SAs. The significance of the SAs given their statutory nature has already been emphasised in the previous section. The additional partner, CA Shrenik Baid had tried to contend that the ultimate responsibility of the audit report issued by the firm fell on CA Udayan Sen, who was the engagement partner. The NFRA held that the duty to discharge the SAs does not solely lie with the engagement partner (in this case CA Udayan Sen) but on the whole Engagement Team. The reasoning NFRA gave is that the engagement partner's role requires them to provide leadership to the engagement team during the audit. But this does not shift all responsibility to the engagement partner alone. Moreover, the NFRA was of the opinion that the additional partner's attempt to shift the blame made his professional misconduct all the more serious.

The third factor referred to the maintenance of investor confidence, as audited financial statements are a necessary input for any decision they make. Auditors are thus charged with a duty to calibrate their approach based on what they judge to be the significance of the audit operation. Negligence in this regard would warrant a severe penalty. In the present case, there was a severe breakdown of public and investor confidence, and this was taken into account by the NFRA in all its orders relating to IL&FS.

The fourth factor refers to reckless behaviour. Auditors are expected to know the SAs and the consequences of not following them. Where such consequences are reasonably seen (and based on the NFRAs approach, they usually are foreseeable), the professional misconduct becomes all the more serious.

Fifth and finally, the NFRA stressed on the need to deter auditors from "going along" with fraudulent practices of the company's management. In this case, for instance, the company had deliberately misstated that it had ceased to comply with RBI regulations about net owned funds. And the auditors did not fulfil their duties in challenging this (see section above for details about this charge).

[74] Order Under Section 132(4) of the Companies Act in respect of the Show Cause Notice issued to CA Rukshad Daruvala paragraph 87.

NFRA imposed the most severe penalty on the engagement partner, who was barred from practicing for a period of seven years (ten being the maximum period for which an auditor can be barred under Section 132(4) of the Companies Act 2013)) and made to pay a fine of INR 2,500,000. The second most severe penalty was imposed on the additional partner who was fined INR 1,500,000 and barred from practicing for five years. Finally, the EQCR partner was barred from practicing for five years and was fined an amount of INR 500,000. The NFRAs emphasis on the role of the engagement partner in this particular audit could lead one to conclude that the severity of the engagement partner's penalty is attributable to his lead role in the audit. The NFRA stated that the role of the engagement partner was to provide leadership so that the engagement team could achieve the "necessary audit quality".[75] Similarly, the additional partner also occupied a senior position but was not formally the engagement partner, thus both of them incurred severe penalties reflecting their differentiated levels of responsibility vis-à-vis the audit. The EQCR's penalty is significant and shows that those reviewing the audit need to be just as vigilant as those auditing the firm and discharge their duties in strict compliance with the SAs. Notably, the EQCR partner was barred from practicing for the same period of time as the additional partner, albeit with a lower monetary penalty.

The other three orders of the NFRA that do not pertain the IL&FS audit lack such a detailed explanation of the factors that went into deciding the penalty. This may be attributable to the overall significance of the audit and its ability to jeopardise public trust. In the order against CA Gulshan Jham, the NFRA looked at his non-compliance with SAs, the role of disciplinary proceedings and auditors in promoting confidence and trust among investors, and finally, the nature and size of the audit firm.[76] With regards to the last factor, the NFRA noted that the CA was from a small audit firm which had not audited any other listed company. Furhter, the CA had admitted to the lapses committed. The NFRA used this rationale as an application of the principle of proportionality and imposed a less severe penalty – a monetary fine of INR 100,000 and the auditor was barred from practicing for a period of one year.[77] The need to deter fraud or collusive behaviour and reckless behaviour of which the consequences were foreseeable are

[75] Order under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Udayan Sen at 86.
[76] Order Under Section 132(4) of the Companies Act in repsect of Show Cause Notice Issued to CA Gulshan Jham paragraph 25.
[77] Order Under Section 132(4) of the Companies Act in repsect of Show Cause Notice Issued to CA Gulshan Jham paragraph 26.

two factors that were not considered in the order against Gulshan Jham, but were noted in all IL&FS Orders.

In CA Som Prakash Aggarwal order,[78] the NFRA considered loss of investor confidence and emphasised that the repercussions of negligent audits go beyond the audited corporation and create a loss of trust and confidence in the minds of investors about the reliability of financial information. In addition to this factor, the non-compliance with SAs and the value of sanctions as having a signalling and deterrent effect that goes beyond the auditor being sanctioned were also considered.[79] This was the reasoning used in the order against CA Rajiv Bengali as well.[80]

IV. Assessing the NFRA's Approach

The NFRA orders mark a shift in the benchmark used by High Courts for ascertaining both the existence of gross negligence and misconduct by auditors.[81] High Court decisions demonstrated inconsistency on the issue of whether an mental element or some intention was necessary for a finding of gross negligence. In the three IL&FS cases, reference is made to "reckless behaviour" which would be a mental element accompanying negligence. However, findings of gross negligence were made on individual charges on the basis of non-compliance with SAs. In the three orders not related to the IL&FS cases, recklessness was not considered as a factor. A smaller penalty was imposed in each of these cases, but what seemed to be a decisive factor in the scale of penalty was the significance of the audit and its overall effect on investor confidence.

Overall, a review of the six orders suggests, the NFRA's approach to auditors' liability has no doubt been consistent. However, by reading entries under Schedule II of the Chattered Accountants Act in light of the statutory nature of the SAs, it is unclear how the NFRA will maintain a distinction between a lapse in due diligence and gross negligence. For instance, even in the decision where the auditor was debarred for the mandatory minimum period of time, the NFRA had made a finding of gross negligence. Once again, this was for not strictly complying with the SAs. It is possible that the jurisprudence of the NFRA will refine overtime as it decides

[78] Order Under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Som Prakash Aggarwal (ICAI Membership No. 74813).
[79] Order Under Section 132(4) of the Companies Act in respect of Show Cause Notice Issued to CA Som Prakash Aggarwal (ICAI Membership No. 74813) paragraph 11.1-12.1.
[80] Order under Section 132(4) of the Companies Act with respect to Show Cause Notice Issued to CA Rajiv Bengali paragraph 31.
[81] Mohan and Raj, "Auditors' Negligence and Professional Misconduct in India," 122.

more cases. Specifically, the NFRA may consider making a finding of a lapse in due diligence rather than the commission of gross negligence in the following circumstances. Where the "significance" of the audit is not enough to warrant a severe penalty or where the lapse has been limited to a single occurrence or SA rather than multiple violations. This may conceptually be easier to reconcile than a situation where gross negligence (of varying degrees) can warrant a penalty of being banned form auditing PIEs for 7 years and 1 year. While the NFRA is meticulous in its identification of SAs and the exact violation that occurred, it may consider translating this into nuancing its conclusion on the exact basis of professional negligence.