CHAPTER V

AUDIT AS A MEANS OF PROTECTION OF INVESTORS

5.1 INTRODUCTION

Audit is a formal examination and verification of financial accounts and records of an organisation. It has become an essential requirement for good corporate governance as it plays a major role in ensuring transparency and accountability in the corporate financial administration, so auditors are, often, referred to as gatekeepers. A company carries on business with capital provided by persons who are not in control of the use of the money supplied by them. They would, therefore, like to see their investments are safe, being used for intended purposes and the annual accounts of the company present a true and fair view of the state of affairs of the company. For this purpose, the accounts of the company must be checked and audited by a duly qualified and independent person who is neither employed in the company nor is in any way indebted or otherwise obliged to the company.¹ The contract under which the work of a company’s auditor is with the company should be as a separate person. Like anyone who renders professional services for reward, a company’s auditor owes the company an implied contractual duty of care in and about the manner in which the audit is performed.² The nature of an auditor’s duty of care in the performance of an audit was considered by Lopes LJ in Re Kingston Cotton Mill Co (No-2)³ which is relevant, even, today also-

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¹ Majumdar A.K and Kapoor, Company Law and Practice, 15th ed, Taxmann, Page No. 819
³ (1896) 2 Ch 279 at pp 28-89
“It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog, but not a bloodhound……an auditor does not guarantee the discovery of all fraud.”

According to Lord Denning,

“An auditor is not bound to be confined to the mechanics of checking vouchers and making arithmetical computations. He is not to be written off as a professional adder-upper and subtractor. His vital task is to take care to see that errors are not made, be they errors of computation, or errors of omission or commission, or downright untruths. To perform this task properly he must come to it with an inquiring mind- not suspicious of dishonesty, I agree- but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none.”

Sections 138 to 148 of the Companies Act, 2013 deal with audit and auditors. Now, internal audit by qualified auditors has been made mandatory as per section 138 of the Act. The Board of directors shall decide for internal audit in the manner prescribed by the Central Government. Every company appoints an individual or firm as an auditor in the annual general meeting (AGM) who hold office for five years and he is also be present in every AGM. Section 144 of Companies Act, 2013 provides for the services which the auditor cannot perform directly or indirectly to the company or its holding company, subsidiary company or associate company.

There are civil and criminal liabilities, through section 147, imposed on auditor and on the partner(s) of an auditor firm who has audited in contravention of

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5. Fomento (Sterling Area) Ltd v. Selsdon Fountain Pen Co Ltd , (1958) 1 WLR 45
provisions of the Companies Act, 2013. In the present chapter, meaning of audit, qualification of auditors, essentials for their appointment, their powers and duties, their civil and criminal liabilities have been dealt in the light of the Companies Act, 2013 and how audit is an important means to protect the investor’s interests has been discussed.

5.2 MEANING OF AUDIT

As stated above, Audit is a formal examination and verification of financial accounts and records of any organisation. It is defined as a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing the auditor perceives and recognizes the propositions before him for examination, collects evidence, evaluates the same and on this basis formulates his judgment which is communicated through his audit report. The purpose is then to give an opinion on the adequacy of controls (financial and otherwise) within an environment they audit, to evaluate and improve the effectiveness of risk management, control, and governance processes.⁶

When there is inequality of information between parties, it is desirable, not only between parties concerned, but also from a wider social perspective that the accounts should be attested by an independent third party. A prospective purchaser of a company’s share will require this information before he commits himself to investing in the company. The established convention is to have an independent third party, an auditor, to validate this information.⁷

An audit must adhere to generally accepted standards established by governing bodies. These standards assure third parties or external users that they can rely upon the auditor's opinion on the fairness of financial statements, or other subjects on which the auditor expresses an opinion.

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6. Audit and Assurance Standard (AAS-1), ICAI.
7. Charlesworth’s Company Law, 18th edn. (London Sweat and Maxwell, 2011) at page No. 481
Audit has revealed many corporate frauds in the past and it is an important means to protect the interests of investors. It plays a major role in ensuring transparency and accountability in the corporate world, thus they are often called as gatekeepers. Auditing is the central to the public confidence in financial disclosures especially as an auditor is considered to be an intermediary between firms and investors in respect of corporate financial statements. Auditors act as eyes and ears of the shareholders and prospective investors, thus, to instill confidence in market and to provide a true and fair account of the company the role of an unbiased objective auditor is an undeniable necessity.

5.3 OBJECTIVE AND SCOPE OF AUDIT

A company carries on business with capital provided by persons who are not in control of the use of the money supplied by them. They would, therefore, like to see whether their investments are safe, being used for intended purposes or not. At the same point of time annual accounts of the company present a true and fair view of the state of affairs of the company.\(^8\) Thus, to maintain investor’s confidence in the reliability of company, the accounts of the company must be checked and audited by a duly qualified and independent person who is neither employed in the company nor in any way indebted or otherwise obliged to the company. It is a formal examination and verification of financial accounts and records of any organisation and now, it has become an indispensable part of good corporate governance as it plays a major role in ensuring transparency and accountability in the corporate financial administration. It is also a mechanism through which interest of the investors can be safeguarded.

Originally, the audit function was primarily a public function. Its objective was to detect fraud and error.\(^9\) Dicksee in his text book on auditing has outlined the objectives of an audit as\(^10\):-

\[(i)\] The detection of fraud

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(ii) The detection of technical errors

(iii) The detection of errors of principle

The means for achievement of such an objective is a detailed analysis of transactions. He has mentioned the concept of internal check and pointed out that when a good system of internal check exists, a detailed audit is frequently not necessary in its entirety.

With the passage of time and the growth of enterprises to the size that made significantly improved internal system of control economical, a detailed audit of transactions became impractical and the objectives of the audit function changed significantly. The auditor’s report on financial statements became an end product rather than merely an evidence of absence of fraud.

The **Institute of Chartered Accountants of India** has also enumerated the following as the objective of auditing the financial statements:\(^{11}\)

1. Objective of auditing the financial statements prepared within a framework of recognized accounting policies and practices and relevant statutory requirement, if any, is to enable an auditor to express an opinion on such financial statements.

2. The auditor’s opinion helps in determination of the true and fair view of the financial position and operating results of an enterprise. The user however should not assume that the auditor’s opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.

### 5.4 INTERNAL AUDIT OF THE COMPANY

A new provision is added in the Companies Act, 2013, regarding internal audit of the company. Section 138 of the Act provides that such class or classes of companies as may be prescribed shall be required to appoint an internal auditor, who shall either be a chartered accountant or a cost accountant, or such other

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\(^{11}\) Statement on objective and scope of audit of financial statement, ICAI.
professional as may be decided by the Board to conduct internal audit of the functions and activities of the company. The Central Government may, by rules, prescribe the manner and the intervals in which the internal audit shall be conducted and reported to the Board. There was no such provision for mandatory internal audit in the Act of 1956.

Therefore, the main objective of auditing is the evaluation of financial statement to see whether they truly and fairly represent the actual financial status of the organization. Detection of frauds and errors is only an incidental objective. Auditor is often in a position to discover frauds. If after the auditor has completed his audit, a fraud is discovered pertaining in that period, it does not necessarily mean that the auditor has been negligent or that he has not performed his duties completely. The auditor does not guarantee that once he has signed the report on the accounts, no fraud exists. If he has conducted his audit by applying due care and skill in consonance with the professional standards expected, the auditor would not be held responsible for not having discovered that fraud.\textsuperscript{12}

5.5 ELIGIBILITY AND QUALIFICATIONS OF AUDITOR

In India, an auditor should be a chartered accountant under the Chartered Accountants Act, 1949 who is appointed to examine the books of account and the accounts of a company registered under the Companies Act, and to report upon them to the company’s shareholders.\textsuperscript{13} A firm may be appointed in its name provided majority of partners practicing in India are qualified for appointment as auditor.\textsuperscript{14}

Where a firm including a limited liability partnership is appointed as an audit firm of a company, only the partners who are chartered accountants are authorised to act and sign on behalf of the firm.\textsuperscript{15} Therefore, only a practicing chartered accountant holding a certificate of practice is eligible to be appointed as an auditor.

\begin{footnotes}
\item[13] S. 141 of the Companies Act, 2013(hereafter referred as the Act)
\item[14] Proviso of s.141 of the Act
\item[15] S.141(2) of the Act
\end{footnotes}
of the company. Further, such a chartered accountant is also subjected to the requirements of ethical conduct as contained in the Chartered Accountant (C.A) Act, 1949.

In *Council of the Institute of Chartered Accountants of India v. B. Ram Goel*, the Delhi High court held that the Chartered Accountant concerned is guilty for writing a letter to the shareholders of a company where he rendered professional service, for sale of their shares in that company (originally the Council of the Institute held the Chartered Accountant as guilty).

In *Institute of Chartered Accountants of India v. S.K. Jain*, the Delhi High court held that the Chartered Accountant concerned as guilty of gross negligence in certifying a statement of export of leather goods, without verifying facts from relevant books or documents of the concerned company.

In United Kingdom, an auditor is an officer of the company for the purpose of a misfeasance summons under section 212 of the U.K’s Insolvency Act, 1986 and for the purposes of offences under sections from 206 to 211 and section 218 of that Act. Where an Auditor is retained to conduct and carry out the audit function without appointment as an Auditor, he may not be treated as officer of the company.

**5.6 DISQUALIFICATIONS OF AUDITOR**

The following persons are **not eligible** for appointment as an auditor of a company, namely:—

(a) a body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008;

(b) an officer or employee of the company;

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16. [2001] 29 SCL 257
17. [2001] 29 SCL 265
18. Charlesworth’s *Company Law*, 18th edn. (London Sweat and Maxwell, 2011) at page No. 487 and in *Re London and General Bank (1895) 2 Ch. 166 CA.*
20. S. 141(3) of the Act
(c) a person who is a partner, or who is in the employment, of an officer or employee of the company;

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

   (i) is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company; or

   (ii) is indebted to the company, or its subsidiary, or

   (iii) has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, or its subsidiary.

(e) a person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company,

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

(g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies;

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

(i) any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialized services as provided in section 144.

5.7 APPOINTMENT OF AUDITORS

Section 139 of the Companies Act, 2013 describes the various provisions for the appointment of auditors having requisite qualifications and other eligibilities. They
can be appointed by the Board of directors as first auditors, or by shareholders in the Annual General Meeting as subsequent auditors. Thus they are appointed by-

(a) by Board of directors

(b) by shareholders in the Annual General Meeting

(c) by the Central Government

5.7.1 APPOINTMENT BY BOARD OF DIRECTORS

The first auditor of a public company is appointed by the Board of directors within thirty days from the date of registration of the company. The auditor(s) so appointed shall hold office until the conclusion of the first annual general meeting. If the Board fails to appoint such auditor, it shall inform the members of the company, who shall within ninety days at an extraordinary general meeting appoint such auditor and such auditor shall hold office till the conclusion of the first annual general meeting.21

In case of casual vacancy, which has been created as a result of the resignation of an auditor, such appointment against the vacancy should be filled up by the company at a general meeting convened within three months of the recommendation of the Board and such auditors shall hold the office till the conclusion of the next annual general meeting.22

The appointment of the first auditor of a company through the Memorandum of Association and Article of Association of the newly company is not a valid appointment since the Companies Act grants no recognition. Therefore, the first auditors would be validly appointed only by a resolution of the Board of directors or that of the company in the general meeting.

21. S. 139(6) of the Act
22. S. 139(8)
5.7.2 APPOINTMENT BY SHAREHOLDERS IN THE ANNUAL GENERAL MEETING

Generally, auditors are appointed by shareholders in annual general meeting either through passing ordinary or special resolution. Appointment of subsequent auditors of the company is made in the first annual general meeting through passing ordinary resolution.

Section 139(1) of the Act provides that every company shall, at the first annual general meeting, appoint an individual or a firm as an auditor who shall hold office from the conclusion of that meeting till the conclusion of its sixth annual general meeting. But, matter relating to such appointment shall be placed for ratification by members at every annual general meeting.

In this way, the subsequent auditors are appointed by the members of the company in annual general meeting by passing an ordinary resolution. The tenure of such subsequent auditors is fixed for five years.

The proviso of the section 139(1) further provides that before such appointment is made, the written consent of the auditor proposed to be appointed should be obtained along with a certificate from him. The Companies (Audit and Auditors) Rules 2014 require the auditor to certify that –

(i) he is eligible for appointment and not disqualified for appointment under the Act, the Chartered Accountant Act, 1949 and the rules or regulations made there under,

(ii) the proposed appointment is as per the term provided under the Act,

(iii) the proposed appointment is within the limit laid down by the authority of the Act,

(iv) the list of proceedings against the auditor of audit firm or any partner of the audit firm pending with respect to professional matters of conduct, as disclosed in the certificate is true and correct.
Where a company is required to constitute an Audit Committee under section 177, all appointments, including the filling of a casual vacancy of an auditor under this section shall be made after taking into account the recommendations of Audit Committee.\(^2^3\)

**Intimation of Appointment** - the Company should inform the auditor concerned of his or its appointment, and also file a notice of such appointment with the Registrar within fifteen days of the meeting in which the auditor is appointed.\(^2^4\)

### 5.7.3 APPOINTMENT OF AUDITOR BY THE CENTRAL GOVERNMENT

Section 139(7) of the Act prescribes that in the case of a Government company or any other company owned or controlled, directly or indirectly, by the Central Government, or by any State Government, or Governments, or partly by the Central Government and partly by one or more State Governments, the first auditor is appointed by the Comptroller and Auditor-General of India (CAG) within sixty days from the date of registration of the company.

In case the CAG of India does not appoint such auditor within the abovementioned period, the Board of directors of the company shall appoint such auditor within the next thirty days and in the case of failure of the Board to appoint such auditor within the next thirty days, it shall inform the members of the company who shall appoint such auditor within the sixty days at an extraordinary general meeting.

The first auditor so appointed hold office till the conclusion of the first annual general meeting.

### 5.8 CEILING ON AUDIT

According to section 141 (3) (g), the following persons are not eligible for appointment as an auditor of a company, namely:

- (a) a person who is in full time employment elsewhere,
(b) a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies;

So, a person cannot be auditor of more than twenty companies at a time. In case of a firm of auditors, it shall be construed as partner of the firm who is not in full time employment elsewhere. As the expression used here is ‘twenty companies’ without any exception, it implies that the restriction applies to private companies, one person companies and small companies as well.²⁵

5.9 TENURE OF OFFICE OF AUDITOR

An individual auditor or an audit firm is appointed, at the first annual general meeting who shall hold office from the conclusion of that meeting to till the conclusion of its sixth annual general meeting and thereafter till the conclusion of every sixth meeting.²⁶ Such meeting is called the first meeting. If the annual general meeting (AGM) is not held within the period as prescribed by section 96 of the Act, the office of auditors shall not be vacant. He is expected to continue in office till the AGM is actually held and concluded. In this way, if an AGM is adjourned, the tenure of auditor will extend till the conclusion of the adjourned meeting.

If no auditor is appointed in AGM- section 139 (11) of the Act provides that if at an AGM no auditor is appointed or reappointed, the existing auditor shall continue to be the auditor of the company.

Nevertheless an auditor is appointed for a period of five years as aforesaid, the matter relating to such appointment needs to be placed before the members at every AGM for their ratification. The company has also a right to remove the auditor before completion of his tenure.

²⁶ S.139(1)
5. 10 COMPULSORY ROTATION OF AUDITOR

A new provision of compulsory rotation of auditors by listed companies and classes of companies has been prescribed in the Companies Act, 2013. Section 139 (2) of the Act has prescribed for compulsory rotation of the auditors for the listed companies and certain class or classes of companies. Such class of companies is notified in the Rule 5 of Companies (Audit and Auditors) Rules, 2014. Under this section, such companies shall not appoint an individual as auditor for more than one term of five consecutive years whereas an audit firm shall not be appointed for than two terms of five consecutive years. After the expiry of the period as aforesaid the auditors are required to be rotated. Rule 6 (3) (i) of Companies (Audit and Auditors) Rules, 2014 prescribed that for the purpose of calculating the period of five consecutive years or ten consecutive years as prescribed , the period for which the auditor has held office prior to the commencement of the Act shall also be taken into account. The proviso to section 139 (2) allows a period of three years to the company from the commencement of the Act to comply with the requirements relating to rotation of auditors.

5.11 COOLING OFF PERIOD OF AUDITORS

In order to ensure auditor independence and to prevent any kind of nexus that may develop between the company and auditor, a new provision of cooling off period of auditor(s) has been incorporated in section 139 (2) in the Companies Act, 2013. Proviso of Section 139 (2) states that an individual auditor or audit firm that has completed the prescribed tenure of five years or ten consecutive years respectively shall have the cooling off period of five years during which he shall not be eligible.

27. Rule 5 of The Companies (Audit and Auditors) Rules, 2014, as notified w.e.f. 1st April 2014 -For the purposes of sub-section (2) of section 139, apart from listed companies, the class of companies shall mean the following classes of companies excluding one person companies and small companies:-
(a) all unlisted public companies having paid up share capital of rupees ten crore or more;
(b) all private limited companies having paid up share capital of rupees twenty crore or more;
(c) all companies having paid up share capital of below threshold limit mentioned in (a) and (b) above, but having public borrowings from financial institutions, banks or public deposits of rupees fifty crores or more.
for re-appointment as auditor in the same company. Therefore the Act has prescribed a compulsory break up of five years before the auditor or the firm becomes eligible for re-appointment as auditor in the same company. The proviso further provides that the cooling off requirement even applies to an audit firm which has one or more common partner with the audit firm that is being rotated. Rule 6 (3) (ii) of Companies (Audit and Auditors) Rules, 2014 also provides that an the incoming auditor or audit firm shall not be eligible if such auditor or audit firm is associated with the outgoing auditor or audit firm under the same network of audit firms i.e. the firms operating or functioning under the same brand name, trade name or common control.

5.12 REMUNERATION OF AUDITORS

The remuneration of the auditor of a company is fixed in its AGM or in such manner as may be determined in AGM. The Board of director may fix remuneration of the first auditor appointed by it. It is not necessary that the amount of remuneration be specified by the company in its AGM. It would be enough if the manner in which the remuneration is to be fixed is laid down in the AGM. It is also not necessary that the remuneration be fixed in the same AGM in which the auditor is appointed.

The term ‘remuneration’ means any sum paid by the company in respect of the auditor’s expenses in carrying out his duties including the expenses, if any, incurred by the auditor in connection with the audit of the company and any facility provided to him. However, an auditor may receive separate remuneration for services rendered other than the audit work (e.g., for advising on taxation matters).

5.13 RE-APPOINTMENT OF RETIRING AUDITORS

A retiring auditor may be re-appointed as auditor for the same company. Section

28. S.142(1)
139(9) of the Act provides that a retiring auditor may be re-appointed at an AGM, if-

(i) he is not disqualified for re-appointment;

(ii) he has not given the company a notice in writing of his unwillingness to be re-appointed; and

(iii) a special resolution has not been passed at that meeting appointing some other auditor or providing expressly that he shall not be re-appointed.

The re-appointment of auditor is not automatic. It is subject to approval of members in the AGM. If a retiring auditor is not re-appointed in AGM, it does not mean that he has been removed. In such cases it is the simple retirement of the auditor.

5.14 FILLING UP CASUAL VACANCY OF AUDITORS

A casual vacancy of auditor denotes a vacancy caused by a validly appointed auditor ceasing to act as such, (e.g. due to death, disqualification etc.). Therefore a casual vacancy is not a vacancy created by any deliberate omission on the part of the company to appoint an auditor at its AGM. According to the section 139 (8) of the Act, the Board of directors is empowered to fill any casual vacancy of the auditor caused other than resignation of an auditor within thirty days. If the casual vacancy is caused by the resignation of an auditor, it can only be filled by the company in AGM which is to be convened within three months of the recommendation of the Board of directors. Such appointed auditors shall hold the office till the conclusion of the next AGM.

In the case of a company other than a company whose accounts are subject to audit by an auditor appointed by the CAG of India, be filled by the Board of directors within thirty days, but if such casual vacancy is as a result of the resignation of an auditor, such appointment shall also be approved by the company in AGM which is to be convened within three months of the recommendation of the Board and he shall hold the office till the conclusion of the next AGM.
Section 140(2) of the Act prescribes that, if an auditor resigns from his office before the expiry of his term, he is required to file a statement with the Registrar within thirty days of the date of resignation. The statement stating the reasons and other facts relevant to resignation shall be filed in the form ADT-3 prescribed in the Companies (Audit and Auditor) Rules, 2014. If the auditor does not comply, he shall be punishable with fine which shall not be less than fifty thousand rupees but which may extend to five lakh rupees.\(^{29}\)

### 5.15 REMOVAL OF AUDITORS

A company has right to remove an auditor, at any time, from the office.\(^{30}\) However in order to make the removal of independent and conscientious auditors difficult, the Act has laid down specific procedure in this regard. Similarly obligation has been casted on the resigning auditor to clearly mention the reasons thereof.

### 5.16 REMOVAL OF AUDITORS BEFORE EXPIRY OF THEIR TENURE

Section 140(1) of the Act states that a auditor may be removed at any time from his office before the expiry of his term only by passing a special resolution of the company, after obtaining the previous approval of the Central Government and giving a reasonable opportunity of being heard to such auditor. The matter of the removal is first considered in the Board’s meeting and necessary resolution is passed. The auditor proposed to be removed need to be given an opportunity of being heard. An application is made to the Central Government in Form ADT-2 prescribed under the Companies (Audit and Auditors) Rules, 2014 within thirty days of passing such resolution of the Board. Within sixty days of the Central Government’s approval, the general meeting of the members shall be held for passing the special resolution to remove such auditor.\(^{31}\)

\(^{29}\) S.140(3)  
\(^{30}\) Proviso of s.139(2)  
\(^{31}\) Rule (7) of the Companies (Audit and Auditors) Rules, 2014
In *D.K. Jain v. Union of India*, the High Court of Delhi upheld the removal of auditor when illegality of removal procedure was challenged by the petitioner, as according to him the decision was already taken by the Board and only subsequent approvals of the Central Government and of the general meeting were obtained. The court was of the view that legally laid down procedure has been followed. The earlier decision of the Board does not matter.

In *M.S. Kabli v. Union of India*, the Delhi High Court declined to uphold removal of the statutory auditor as it found that all the grounds concerning the job performance cited by the company in its application to the Regional Director seeking approval of the removal of the statutory auditor were rejected by the Regional Director, who surprisingly accepted the remaining ground that the company has lost its confidence on the statutory auditor. The court held that the Regional Director will have to be satisfied that the reasons for removal are genuine, keeping in view the best interest of the company and consistent with the need to ensure professional autonomy to the auditor.

Therefore, the prior approval of the Central Government may be taken even after passing the Board’s resolution to remove but it must be before the AGM to pass decision and actual act of removal. It may even be permissible for the AGM to pass a resolution to remove an auditor, subject to approval taken from the Central Government, before actually issuing the removal communication. The High Court is not likely to interfere in the matter without any strong legal justification.

### 5.17 REMOVAL OF AUDITORS BY THE TRIBUNAL

The Tribunal is empowered to direct the company to remove the auditors in certain circumstances. Section 140 (5) states that the Tribunal is satisfied either *suo motu* or on an application made to it by the Central Government or by any person concerned, 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.

If the application under Section 140(5) as aforesaid 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.

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 such auditor shall also be liable for action for fraud, under section 447.35

In case of auditor is a firm, the restriction applies to its partners, parent, subsidiary or associate entity or an entity in which the firm or partner, in which the firm or any partner of the firm has significant influence or control. If the auditor, individual or firm is using name trade mark or brand of another entity, the restriction also applies to that other entity.36

5.18 POWERS OF AUDITOR

It is an established rule that the auditors are to play a vigilant and objective role in ensuring that the investor’s interests are well protected and that the management of the company has acted within reason37. It is the investors who primarily depend on the good faith and efficiency of the company's auditor to ensure that company's actions in the day-to-day operations are verified.38 The Companies Act, 2013 enjoins certain duties upon the auditor and also gives him certain powers to enable him to discharge these duties effectively.39 These duties and rights cannot be

35. Proviso of s. 140 (5)
36. Explanation of S. 144
37. Please refer, further, the Article of Author written with guide Prof.(Dr.) Tabrez Ahmad, “Role Of Audit to Protect Investor’s interest under Companies Act, 2013” Emerging Researcher, Vol.1 Issue III (Jul-Sep 2014).
39. S.143
limited or abridged in any way. Thus, a resolution limiting the powers of the auditor or a provision to this effect in the Articles of Association will be void.40

In *Newton v. Birmingham Small Arms Co. Ltd*, it was held that any regulations which preclude the auditors from availing themselves of all the information to which they are entitled are inconsistent with the Act.41 The rights of auditor includes-

1. Right of access to books and accounts, etc.
2. Right to obtain information or explanation
3. Right to visit and inspect branch accounts of the company
4. Right to sign audit reports
5. Right to attend and speak in general meeting
6. Right to view and study the Article of Association, Memorandum of Association, Prospectus, important contracts of the company etc.

**5.18.1 RIGHT OF ACCESS TO BOOKS AND ACCOUNTS, ETC**

Every auditor has right of access to the books and accounts and vouchers of the company. He may require from the officers of the company any information he thinks necessary for the performance of his duty.42 If any of the provisions of Act (i.e. sections 139 to 146) is contravened, the company shall be punished with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees, or with both.43

The auditor has to submit a report on the accounts of the company, prepared by its directors, to the members of the company. The report is required to state whether

41. (1906), 2 Ch. 378
42. Singh Dr. Avtar, *Company Law*, 15th edn 2007, p.455, EBC
43. S. 147
the accounts are kept in accordance with the provisions of the Act and whether they give a true and fair view of the state of affairs of the company according to accounting standards. In order to prepare an auditor’s report, investigations must be carried out which are sufficient to enable the auditor to form an opinion on whether the accounting records have been kept by the company and whether the accounts for the financial year and the director’s remuneration report agree with those accounting records. The auditor is required to sign the audit report after duly verification.

The signed and certified audit report of every financial year is required to be submitted to the members of the company and also to be laid before the company in general meeting. This report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made with that effect and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company’s affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed. The auditor has also duty to state-

(a) the details of all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;

(b) the proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;

(c) whether the company’s balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;

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45. S.143(3)
(d) whether, in his opinion, the financial statements comply with the accounting standards;

(e) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;

(f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;

(g) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

5.18.2 RIGHT TO OBTAIN INFORMATION OR EXPLANATION

Section 143 (1) is also entitled the auditor of a company to seek such information and explanation as he may consider necessary for the performance of his duties as auditor, from the officers of the company into the following matters, namely:—

(a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

(b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

(c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company,

(d) whether loans and advances made by the company have been shown as deposits,

(e) whether personal expenses have been charged to revenue account,

(f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in
respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

5.18.3 RIGHT TO VISIT AND INSPECT BRANCH ACCOUNTS OF THE COMPANY

Where a company has a branch office, the accounts of that office shall be audited either by the auditor appointed for the company (herein referred to as the company’s auditor) under this Act or by any other person qualified for appointment as an auditor of the company under this Act and appointed as such under section 139, or where the branch office is situated in a country outside India, the accounts of the branch office shall be audited either by the company’s auditor or by an accountant or by any other person duly qualified to act as an auditor of the accounts of the branch office in accordance with the laws of that country and the duties and powers of the company’s auditor with reference to the audit of the branch and the branch auditor, if any, shall be such as may be prescribed:

Provided that the branch auditor shall prepare a report on the accounts of the branch examined by him and send it to the auditor of the company who shall deal with it in his report in such manner as he considers necessary.46

5.18.4 RIGHT TO SIGN AUDIT REPORTS

The mandate of the section 145 requires that only the person appointed as an auditor of the company has the right to sign the auditor’s report or sign or certify any other document of the company. Where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants shall be authorised to act and sign on behalf of the firm.47 if a audit firm is appointed for the audit of the company, only a partner in the firm can sign the audit report or authenticate any other documents required to be signed or authenticated by an auditor. The practice of fixing the “firm name” is not allowed,

46. S. 143 (8)
47. S. 141(2)
at present. The partner should sign his own name for and behalf of the firm which has been appointed auditors of the company.

5.18.5 RIGHT TO ATTEND AND SPEAK IN GENERAL MEETING

The auditor of the company has the right to attend the AGM. Section 146 entitles the auditor with this right and also with the right to be heard in general meetings on any part of the business which concerns him as the auditor. The auditor also has right to send his authorised representative to attend the meeting in place of attending the meeting himself personally. In such a case the authorised representative should also be qualified to be an auditor.

Section 145 makes it obligatory that any qualifications, observations or comments on financial transactions or matters, which have any adverse effect on the functioning of the company mentioned in the auditor’s report shall be read before the company in general meeting and shall be open to inspection by any member of the company. The entire auditor’s report need not be read out but only that portions that have any adverse effect on the functioning of the company as aforesaid need to be read in the general meeting.

5.19 DUTIES OF AUDITOR

The primary duty of an auditor is auditing and auditing is a formal examination and verification of financial accounts and records of any organisation. The auditor shall make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company’s affairs as at the end of its financial year and profit or loss and cash flow for the year and
such other matters as may be prescribed. Most of the auditor’s duty has been specifically laid down by the Companies Act and Institute of Chartered Accountants (ICAI). Broadly an auditor has the following two important duties:

1. Statutory duties

2. Duty to exercise standard of care and skill

5.19.1 STATUTORY DUTIES OF AUDITOR

Statutory duties of an auditor is mostly prescribed by the Companies Act and ICAI which includes the following important duties-

(i) Duty to comply with the auditing standards
(ii) Duty to make certain inquiries
(iii) Duty to make report of audit
(iv) Duty to report frauds
(v) Duty to attend general meeting
(vi) Duty to make statement in prospectus
(vii) Duty to produce documents and evidence
(viii) Duty not to render certain services

5.19.1.1 AUDITOR SHOULD COMPLY WITH THE AUDITING STANDARDS

Every auditor should comply with the auditing standards during auditing of any company. Section 143(9) of the Act requires that auditor to comply with the auditing standards as may be prescribed for the performance of the audit. For this purpose the Central Government may prescribe auditing standards as recommended by ICAI in consultation with the National Financial Reporting Authority (NFRA). Till such auditing standards are notified, the standards already specified by the ICAI shall be followed. The ICAI has issued various standards

48. S. 143(2)
49. Proviso of S. 143 (10)
as auditing, review and other standards (SQC). Till auditing standards are notified under the Act, these standards shall be deemed to the standards of audit.

5.19.1.2 DUTY TO MAKE CERTAIN INQUIRIES

Section 143 (1) has imposed a duty to the auditor of a company to make inquiries as he may consider necessary for the performance of his duties, from the officers of the company into the following matters, namely:

(a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interests of the company or its members;

(b) whether transactions of the company which are represented merely by book entries are prejudicial to the interests of the company;

(c) where the company not being an investment company or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company,

(d) whether loans and advances made by the company have been shown as deposits,

(e) whether personal expenses have been charged to revenue account,

(f) where it is stated in the books and documents of the company that any shares have been allotted for cash, whether cash has actually been received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading.

5.19.1.3 DUTY TO MAKE REPORT OF AUDIT

It is the significant duty of an auditor to report to the members of the company on the accounts examined by him and on every financial statement which are required by or under this Act to be laid before the company in general meeting also that the
report shall confirm the position, envisaged in the under-mentioned manner in which the requirements are to be met\textsuperscript{50}.

The Act specifically requires that the auditor should report whether to the best of his information and knowledge of the said accounts and financial statements give a true and fair view of the state of company’s affairs at the end of financial year and the profit and loss and cash flows for the financial year.

Auditor is duty bound to report on the following matters as required by section 143(3) of the Act-

(a) Whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary for audit-

The significance of such a requirement is that the auditor must obtain due satisfaction about the scope of work carried out by him and affirm that in the discharge of his duties he has maintained professional standards of diligence and care. If the answer to this question is negative, he needs to provide details thereof and also report the effects of such information on the financial statements.

Justice Lindley in his famous judgment, in the \textit{Re London and General Bank case}\textsuperscript{51}, propounded his view. The relevant passage from the judgment is quoted below-

\begin{quote}
\textit{“An auditor, however, is not bound to do more than exercise reasonable care and skill in making enquiries and investigations. He is not an insurer; he does not guarantee that the books do correctly show the true position of the company’s affairs; He does not guarantee that his balance sheet is accurate according to the books of the company, if he did, he would be responsible for an error on his part, even if he were himself deceived without any want of reasonable care on his part say, by the fraudulent concealment of a book from him.”}
\end{quote}

\textsuperscript{50} S.143(2)
\textsuperscript{51} (1895) 2 Ch. 166 CA
Similarly, Lopes L.J. also held in his judgment in the case of *Re Kingston Cotton Mills*\(^{52}\) that auditors must not be made liable for not tracking out ingeniously and carefully laid scheme of fraud when there is nothing to arouse their suspicion and when those frauds have been perpetrated by the trusted servants of the company and have been undetected for years by the directors. The relevant passage from his judgment which is still relevant today, quoted below:

“It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog, but not a bloodhound……an auditor does not guarantee the discovery of all fraud.”

Therefore, for the collection of information, the auditor is entitled to rely upon trusted servants of the company; he can accept representations made by them either orally or in writing, provided reasonable care was taken to ensure that the data or information furnished are true and could be trusted to have been prepared in the course of the working of the company. If, however, there are any circumstances that should arouse suspicion, it would be the auditor’s duty to probe it to the bottom. So long as there is not such suspicion, he is only expected to exercise normal caution and care\(^{53}\).

(b) Whether in his opinion, proper books of account as required by law have been kept by the company, so far as papers from his examination of those books and proper returns adequate for the purpose of his audit have been received from branches not visited by him.

The term ‘proper books of account’ has not been defined in the Act, However, it is defined indirectly under sub-section (1) of section 128 wherein it is stated that a

\(^{52}\) (1896) 2 Ch 279

company shall prepare and keep books of account and other relevant papers and financial statements which give a true and fair view of the state of affairs of the company including its branch office or branch offices, as the case may be. Further Section 129 (1) requires that the financial statements shall comply with the notified accounting standards. If the books of account are not meeting these requirements then it shall not be considered ‘proper’.

Further, in section 338 (2), it is provided that a company that is being wound up shall be deemed not to have maintained proper books of account if it had not kept;

(i) such books of account as are necessary to exhibit and explain the transactions and financial position of the business of the company including books containing entries made from day to day in sufficient detail of all cash received and all cash paid; and

(ii) where the business of the company has involved dealing in goods. Statement of annual stock-taking and (except in the case of goods sold by way of ordinary retail trade ) of all goods sold and purchased, showing particulars of goods and those of buyers and sellers in sufficient detail to enable those goods and those buyers and sellers are to be identified.

In the circumstances, proper books of account as required by law are those which contain a record of all the transactions specified both in section 128 and section 338 (2) in a manner that they present a true and fair view of the state of affairs of the financial position and profitability of the company.

The cost records prescribed under section 148 (1) also form part of books of account required to be maintained under the Act.

(c) Whether the report on the accounts of any branch office audited under 143 (8) by a person other than the company’s auditor has been sent to him and how he has dealt with the same in preparing the auditor’s report-

The Research Committee of the ICAI had expressed the views on this matter and an extract there from will be appropriate to quote here-
“Having regard to the scheme of sub-section 228 (2) [corresponding to Section 143 (8) of the Act of 2013], It is clear that though the company in general meeting appoints a branch auditor, the company’s auditor still has a certain measure of responsibility in respect of the accounts and papers of the branch. This is shown by the fact that he has a right to visit the branch and has access to the papers and documents of the branch. He must discharge this responsibility by looking into the branch auditor’s report and satisfying himself that having regard to the report and what he has seen of the branch and documents of the branch, affairs of the branch are in order.”

(d) Whether the company’s balance sheet and profit and loss account dealt with by the report are in agreement with the books of accounts and returns-

The work of an auditor culminates in the verification of statements of account. It is apparent that the duty in this regard, would not be properly discharged if he fails to verify them on making a reference to the books of account before proceeding to make a report thereon. When the auditor reports that proper books of account have been kept and the accounts are in agreement therewith, he confirms that he has discharged the specific duty in this regard imposed on him by the law. If proper books of account have not been kept and if there is a discrepancy in the statements of account and the entries as they appear in the books, he should refer to such a position in his report.

(e) Whether, in his opinion, the profit and loss account and balance sheet have complied with the accounting standards.

As mentioned earlier, Section 129(1) requires that the financial statements shall comply with the accounting standards notified under Section 133. The auditor is required to confirm that the financial statements are in compliance with the accounting standards.

(f) The observations and comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company.
The auditor of a company will have to report on all the financial transactions or all matters which have any undesirable effect on the performance of the company.

(g) **Whether any director is disqualified from being appointed as director under section 164 (2) of the Act**

The auditor of a company will have to report whether any director of the company under audit is disqualified from being appointed as a director of that company because of section 164 (2). Under this section, no person who is or has been a director of a company which-

(i) has not filed financial statements or annual returns for any continuous period of three financial years; or

(ii) has failed to repay the deposits accepted by it or pay interest thereon or to redeem any debentures on the due date or pay interest due thereon or pay any dividend declared and such failure to pay or redeem continues for one year or more, shall be eligible to be re-appointed as a director of that company or appointed in other company for a period of five years from the date on which the said company fails to do so.

(h) **Any qualification, reservation or adverse remarks regarding maintenance of account and other matters connected therewith.**

Any reservation or adverse remarks on maintenance of accounts and related matters need to be reported by the company auditor.

(i) **Whether the company has adequate internal financial controls system on place and the operating effectiveness of such controls –**

The auditor is also required to comment upon the presence and effectiveness of internal financial controls. Maintaining such controls is the primary responsibility of the management. Any weakness observed by the auditors, during the course of the audit shall be mentioned in the auditor’s report.

(j) **Such other matters as may be prescribed**-
**Rule 11 of the Companies (Audit and Auditors) Rules, 2014** has also prescribed the following additional reporting requirements in the auditor’s report:

(a) Whether the company has disclosed the impact of pending litigations on its financial position in its financial statement;

(b) Whether the company has made provisions, as required under any law or accounting standards, for material foreseeable losses on long term contracts including derivative contracts.

**5.19.1.4 AUDITOR’S DUTY IN CASE OF DETECTION OF FRAUD**

As discussed earlier, Auditor is often in a position to discover frauds. In circumstances, when the auditor discover that a senior employee of a company has been defrauding that company on a grand scale, and is in a position to go on doing so, then it will normally be the duty of the auditor to report what has been discovered to the management of the company at once.\(^\text{54}\) The Auditing guidelines, 2000 of ICAI also provides that “during the course of his work the auditor identifies the possible existence of a fraud, other irregularity or error the following action should be taken. The auditor should endeavor to clarify whether a fraud other irregularities or error has occurred ….. unless fraud by senior management is suspected; the auditor should inform senior management of his suspicions. In case of serious fraud or irregularities which is likely to cause to result in material gain or loss for any person or is likely to affect a large number of persons, the auditor may report directly to a third party without the knowledge or consent of the management”.

Section 143(12) of the Act also imposed a duty on the auditor to report to the Central Government if in the course of the performance of his duties as auditor, he has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company.

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\(^{54}\) Ramaiya, *Guide to the Companies Act*, 16th edn pp.2398-2399
Rule 13 of the Companies (Audit and Auditors) Rules, 2014 has prescribed the manner in which the auditor will report the matters related to fraud to the Central Government. According to this rule, the auditor first needs to forward his report immediately to the audit committee or the Board seeking their reply within forty five days. On receipt of reply from the Board or the audit committee, the auditor is required to forward his report, reply or observations of the Board or the audit committee and his comments upon such reply or observations to the Central Government within fifteen days of receipt of such reply Corporate Affairs in a sealed envelope followed by an e-mail as a confirmation.

**Punishment for contravention**- It may be noted here that the duty on the auditor under section 143 (12) is to report any fraudulent activities that he observed in the performance of his duties as auditor. He is not under an obligation to start with the suspicion that a fraud is being committed. If the auditor fails to comply with section 143 (12), he shall be punished with fine which shall not be less than rupees one lakh but may extend to rupees twenty five lakh.\(^{55}\).

In this context, Enron scandal of U.S.A and Satyam Computer scam of India are glaring examples of serious corporate frauds which was occurred with the help of their auditors and auditing firm. These cases have been dealt in detail in Para 5.23 and 5.24 respectively.

**5.19.1.5 DUTY TO ATTEND GENERAL MEETING**

The auditor of the company has the duty to attend the general meeting. Section 146 has imposed this duty on the auditor to attend general meetings either by himself or through his authorized representative unless exempted by the company. The authorized representative shall be the person who should also qualified to be an auditor.

**Scope of duties of an auditor**- The statutory duties of the auditor cannot be limited in any way either by the Article of Association or by the directors or

\(^{55}\) Sub section 15 of Section 143.
members but a company may extend them by passing a resolution at the AGM or making a provision in the Article.\textsuperscript{56}

5.19.1.6 DUTY TO MAKE STATEMENT IN PROSPECTUS

Under sub-clause (iii) of section 26 (1) (b) an auditor is required to make a report which is to be included in the prospectus of a company. Such a report should be made out on -

(a) The profits and losses of the business of the company for each of the five financial years immediately preceding the issue; and

(b) Assets and liabilities of its business on the last date to which the accounts of the business were made up (not more than one hundred and eighty days before the issue the prospectus).

In case of a new company for which the period of five years since incorporation has not lapsed, the report on the profit and losses should cover the period from the date of incorporation.

5.19.1.7 DUTY TO PRODUCE DOCUMENTS AND EVIDENCE

For the purposes of inspection under section 217 of the Act, auditor may be called as an agent of the company and thereby he is duty bound for preserving and producing all books and papers relating to the company to an inspector or any person authorized by him in this behalf with the previous approval of the Central Government, Moreover he is under a duty to give to the inspector all assistance in connection with the investigation which he is reasonably able to give.

5.19.1.8 DUTY NOT TO RENDER CERTAIN SERVICES

Section 144 of the Companies Act, prohibits the auditor to render certain prescribed services directly or indirectly to the company or its holding company or subsidiary company. This is new provision incorporated in the Companies Act, 2013 to ensure that the auditor’s independence and objectivity is not compromised.

\textsuperscript{56} Newton v. Birmingham Small Arms Co. Ltd., (1906), 2 Ch. 378
because of the fees earned by him by rendering other services to the company for which he is acting as an auditor. These services are namely:—

(a) accounting and book keeping services
(b) internal audit
(c) design and implementation of any financial information system
(d) actuarial services
(e) investment advisory services
(f) investment banking services
(g) rendering of outsourced financial services
(h) management services and
(i) any other kind of services as may be prescribed

The Audit committee or the Board of directors is empowered to define the scope of services which are to be rendered by the auditor excluding the services mentioned above. The restriction applies to rendering of such services by the individual auditor, his relative or any other person connected or associated with such individual or through any other entity, whatsoever, in which such individual has significant influence or control.

5.19.2 AUDITOR’S DUTY TO EXERCISE STANDARD OF CARE AND SKILL

A member of the accounting profession, when he is in practice, offers to perform a large diversity of professional services and he also holds himself out to the public as an accountant qualified to accept these assignments. Therefore, when he is appointed under a statute or under an agreement to carry out some professional work it is to be presumed that he shall carry out them completely and with care and diligence expected of a member of the profession. In view, however, of the fact that the standards of competency may vary from individual to individual and also the concept of the function of an audit and that of its technique, may undergo
change from time to time. The auditor is expected to discharge his duties according to "generally accepted auditing standards" obtaining at the time when the professional work is carried out\(^57\).

The Auditors owe a number of duties to the company and its shareholders. The foremost among them is to check the accuracy of accounts. But his duty is not to confine himself merely to the task of verifying the arithmetical accuracy and to ascertain that it was properly drawn up, so as to contain a true and correct representation of the state of the company’s affairs. They should not act merely as a professional adder-upper and subtractor. Here the opinion of Chief Justice Chakravarti of Calcutta High Court is relevant as he expressed in the case *Dy. Secretary v. S.N Das Gupta*\(^58\)-

"A certificate from the management can obviously be no substitute for such verification. The whole object of an audit is an examination of what the management have done and if the statements of the very persons who constitute the management were to be accepted in all matters, even in matters capable of direct verification, an audit would be an idle farce."

In *Re Kingston Cotton Mill Co.* case,\(^59\) it was held that in certain matters of technical nature (for example valuation of stock-in-trade), the auditor will have to rely on some skilled person. Secondly, it has always been the law that an auditor must exercise reasonable care and skill in the discharge of his duty. Justice Romer described this duty in *City Equitable Fire Insurance Co. Re*\(^60\) case and said-

..."He must be honest, i.e., he must not certify what he does not believe to be true and must take reasonable care and skill before he believes that what he certifies is true. What is reasonable care in any particular case must depend upon the circumstances of that case. Where there is nothing to excite suspicion very little inquiry will be reasonably sufficient. Where suspicion is

\(^{57}\) ICAI, Liability of Auditor

\(^{58}\) AIR 1956 Cal. 414

\(^{59}\) (1896) 2 Ch 279 at pp 28-89

\(^{60}\) (1925) Ch. 407 pp. 481-482
aroused more care is obviously necessary; but, still an auditor is not bound
to exercise more than reasonably care and skill even in a case of suspicion
and he is perfectly justified in acting on the opinion of an expert where
special knowledge is required”.

The nature of an auditor’s duty of care in the performance of an audit was
considered by Lopes LJ in *Re Kingston Cotton Mill Co (No-2)* 61 which is
relevant, even, today also-

“It is the duty of an auditor to bring to bear on the work he has to perform
that skill, care and caution which a reasonably competent, careful and
cautious would use. What is reasonable skill, care and caution must depend
on the particular circumstances of each case. An auditor is not bound to be a
detective, or as was said, to approach his work with suspicion or with a
foregone conclusion that there is something wrong. He is a watchdog, but not
a bloodhound…..an auditor does not guarantee the discovery of all fraud.”

An auditor is, however, is not concerned with the policy of the company. In the
words of Lindley LJ 62

“It is no part of an auditor’s duty to give advice, either to directors or
shareholders, as to what they ought to do. An auditor has nothing to do with
the prudence or imprudence of making loans with or without security. It is
nothing to him whether the business of a company is being conducted
prudently or imprudently, profitably or unprofitably. It is nothing to him
whether dividends are properly or improperly declared, provided he
discharges his own duty to the shareholders. His business is ascertained and
stated the true financial position of the company at the time of the audit.

It is also universal true that the auditor owes duty to the company and the company
only, but they also owe duty towards the society. Where an auditor is appointed to
check the accounts of the Employees’ provident fund maintained by a company, he

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61. (1896) 2 Ch 279 at pp 28-89
62. *Re London and General Bank (1895) 2 Ch. 166 CA*
owes not merely to the company, but also to the beneficiaries of the fund and will be responsible to them for professional misconduct if he fails to report that the trustees have allowed irregular loans to the company out of the fund.\textsuperscript{63}

In \textit{Sasea Finance Ltd v. RMPG},\textsuperscript{64} it was held that the auditors of a company discovered that a senior employee had been defrauding the company at a grand scale and that he was in a position to go on doing so, in such a situation it would be the auditors’ duty to report the matter to the company’s management and not to postpone it till they submit their report.

**5.20 AUDITOR NOT LIABLE IF HE IS DECEIVED**

Auditor does audit of the books of account and other related papers what has been produced by the employees of the company including directors. He checks and verifies the books and accounts and vouchers of the company as presented before him. If the auditor himself is deceived by the management of the company and if he has conducted his audit by applying due care and skill in consonance with the professional standards expected, the auditor would not be held responsible for not having discovered that fraud.

In \textit{Trisure India v. A F Ferguson & Co.},\textsuperscript{65} it was held that auditor must be honest and should have reasonable skill and care in ascertaining the company’s books of account, balance sheet and profit & loss account. Reasonable care and skill is not exercised when in spite of the presence of unusual features in the accounts which \textit{prima facie}, give reasons for believing that the accounts are not in order, the examination is not detailed. Where there is nothing at all to excite suspicion and in relying upon the statement of the management, the auditor is himself deceived, then he cannot be said to have failed in discharge of his duties.

In this way, auditing is the central to the public confidence in financial disclosures especially as an auditor is considered to be an intermediary between firms and

\textsuperscript{63} \textit{ICAI v. P.K.Mukherjee} (1968) 2 Comp LJ 211
\textsuperscript{64} (2000) All ER 676 CA
\textsuperscript{65} (1987) 61 Comp Cas. 548 (Bom. HC)
investors in respect of corporate financial statements. Auditors act as eyes and ears of the shareholders and prospective investors, thus to instill confidence in market and to provide a true and fair account of the company, the role of an unbiased objective auditor is an undeniable necessity. Audit has revealed many corporate frauds in the past and it is an important means to protect the interests of investors. It plays a major role in ensuring transparency and accountability in the corporate world, thus they are often called as gatekeepers.

Adversely, if an auditor fails in performing duty of standards of care and skills, he will be held either with civil liabilities or criminal liabilities or with both.

5.21 LIABILITIES OF AUDITOR

The Companies Act, 2013 has prescribed the liabilities of auditor of companies in which he may be held either with civil liabilities or criminal liabilities or with both. There was a significant demand to incorporate stringent criminal liability on auditor(s) in the light of various scams in recent times.

5.21.1 THE CIVIL LIABILITIES OF AUDITOR

The civil liability of an auditor may be for- (i) Negligence, (ii) Misfeasance.

5.21.1.1 LIABILITY FOR NEGLIGENCE

An auditor performs his duties as an agent of the shareholders, so he is expected to safeguard the interests of the shareholders. He must exercise reasonable care and diligence in the performance of his duties. If he fails to do so and in consequence the principal suffers any loss, he may be liable to compensate loss caused to the company resulting from his negligence. If an auditor of a company contravenes any of the provisions of section 139, section 143 to 145 of the Companies Act, 2013, he will be punished with fine which shall not be less than twenty-five thousand rupees but which may be extended up to five lakh rupees.66

66. S.147 (2)
5.21.1.2 LIABILITY FOR MISFEASANCE

Misfeasance means breach of duty or breach of trust. If the auditor does something wrongfully in the performance of his duties or he does not perform his duties properly resulting in a financial loss to the company, he may be held liable for misfeasance. The auditor, who does not report to the shareholders the fact of the case, when the balance sheet is not properly drawn up, is guilty of Misfeasance.67

5.21.2 CRIMINAL LIABILITIES OF AUDITOR

If an auditor has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punished with imprisonment for a term which may extend to one year and with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees. Further if an auditor has been convicted, he will be liable to—

(a) refund the remuneration received by him to the company; and

(b) pay for damages to the company, statutory bodies or authorities or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report.68

Here, it is to be noted that the maximum punishment has been prescribed is only up to one year imprisonment to auditor found guilty of offence as mentioned above.

Subsection (4) of the section 147 further provides that the Central Government shall, by notification, specify any statutory body or authority or an officer for ensuring prompt payment of damages to the company or the persons under clause (ii) of sub-section (3) and such body, authority or officer shall after payment of damages to such company or persons file a report with the Central Government in respect of making such damages in such manner as may be specified in the said notification.

67. Re London and General Bank (1895) 2 Ch. 166 CA
68. Proviso of s.147
In addition, Clause (6) Part I, Second Schedule of the Chartered Accountants Act, 1949, provides that, failure of an auditor to report a known material mis-statement in the financial statements of a company, with which he is concerned in a professional capacity, shall be deemed to be 'professional misconduct'.

5.21.3 PROFESSIONAL MISCONDUCT BY AUDITOR

It is worth to mention here that the Chartered Accountant Act, 1949 has defined serious professional misconducts of an auditor. In these cases of misconduct, the matter is referred to Disciplinary Committee for the decision. Some relevant professional misconduct in respect of false balance sheet in the Second Schedule to the Chartered Accountant Act is mentioned below -

(i) Certifying a report or statement without examination of such statement and related records by him or his partner or employee or other professional in the same field. 69

(ii) Failing to disclose in the report a material mis-statement known to him to appear in a financial statement, with which he is concerned in professional capacity. 70

(iii) Not exercising due diligence or being grossly negligent in conduct of professional duties. 71

(iv) Failed to obtain sufficient information which is necessary for expression of any opinion or its exceptions which are sufficiently material to negate the expression of an opinion (in brief, not collecting enough data or ignoring material facts while expressing an opinion). 72

69. [Clause 2 Part I of Second Schedule]
70. [Clause 6 Part I of Second Schedule]
71. [Clause 7 Part I of Second Schedule]
72. [Clause 8 Part I of Second Schedule]
5.21.4 PUNISHMENTS FOR PROFESSIONAL MISCONDUCT

The Disciplinary Committee formed under Chartered Accountant Act, 1949 can order any one or more of the following actions:

(a) Reprimand the member

(b) Remove name of member from register permanently or for such period as it thinks fit

(c) Impose fine up to Rs. five lakhs.

5.22 LIABILITY OF PARTNER OF AUDIT FIRM

Section 147 (5) has prescribed that in case of audit of a company being conducted by an audit firm, it is proved that the partner or partners of the audit firm has or have acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to or by, the company or its directors or officers, the liability, whether civil or criminal as provided in this Act or in any other law for the time being in force, for such act shall be of the partner or partners concerned of the audit firm and of the firm jointly and severally.

5.23 CASE STUDIES ENRON DEBACLE OF USA

The Enron scandal occurred due to the audit failure in U.S.A in 2001. This was an energy company based in Houston, Texas. This company was formed in 1985 by Kenneth Lay after merging two energy companies Houston Natural Gas and Inter North. After few years, when Jeffrey Skilling was hired, he developed a staff of executives that, by the use of accounting loopholes, special purpose entities, and poor financial reporting, were able to hide billions of dollars in debt from failed deals and projects. This resulted into the company's stock price, which achieved a high of US$90.75 per share in mid-2000, plummeted to less than $1 by the end of November 2001. Chief Financial Officer Andrew Fastow and other executives not only misled Enron's Board of directors and audit committee.

73. [Section 21B(3) of Chartered Accountant Act, 1949]
on high-risk accounting practices, but also pressured their auditor Andersen to ignore the issues.

Enron's audit committee had more expertise than many. It included Dr. Robert Jaedicke of Stanford University, a widely respected accounting professor and former dean of Stanford Business School; John Mendelsohn, president of the University of Texas' M. D. Anderson Cancer Center; Paulo Pereira, former president and chief executive officer of the State Bank of Rio de Janeiro in Brazil; John Wakeham, former U.K. Secretary of State for Energy; Ronnie Chan, a Hong Kong businessman; and Wendy Gramm, former chair of U.S. Commodity Futures Trading Commission.74

The executives of Enron deceived Andersen auditors about the nature and material terms of the deals in question in order to obtain favourable accounting treatment. However, Andersen failed to use due care to investigate whether Enron's counterparties in monetization transactions actually had any money at risk in the transactions; and that Andersen failed in its duty to flag unusual transactions and controversial accounting decisions for Enron's board. Although Andersen was fully aware of the extent to which Enron's reported financial results were the product of accounting manipulation, it did not insist on disclosure of these facts to investors and the Stock Exchange Commission (SEC).

Thus, Andersen gave "substantial assistance" to Enron officers seeking to disseminate misleading financial information. If Andersen had not assisted and enabled Enron's deception, Enron would have been caught years before 2001. Indeed, if Andersen had done its job, Enron would not have been able to deceive the investing public in the first place.75

Andersen was found guilty of illegally destroying documents relevant to the SEC investigation. He was charged with and found guilty of obstruction of justice for shredding the thousands of documents and deleting e-mails and company files that

75. Suman Aastha, Criminal Liabilities of Auditor, retrieved from SSRN id-1658348
tied the firm to its audit of the company. This resulted into cancellation of its license to audit public companies. The damage to the Andersen name has been so great that it has not returned as a viable business even on a limited scale, hence effectively closed its business. Many executives at Enron were also indicted for a variety of charges and some were later sentenced to prison.

As post effect of this scandal, new regulations and legislation were enacted to expand the accuracy of financial reporting for public companies. The Sarbanes-Oxley Act (SOX) was enacted and passed by the U.S parliament, which increased penalties for destroying, altering, or fabricating records in federal investigations or for attempting to defraud shareholders. The Act also increased the accountability of auditing firms to remain unbiased and independent of their clients.

5.23 CASE STUDIES SATYAM COMPUTERS SCAM

In Satyam Computers Scam 2009, has occurred with the help of international repute audit firm PricewaterhouseCoopers (PwC) which is big blow for corporate governance in India. Satyam Computer Services Ltd was founded in 1987 by Mr. B.Ramalinga Raju at Hyderabad, offered information technology (IT) services spanning various sectors, and was also listed on the New York Stock Exchange and Euronext. Satyam's network soon covered 67 countries across six continents. This audit firm failed to detect any fraud and certified some thousands of crores of cash lying in bank accounts that apparently did not exist at all. This scam estimated worth of Rs.7,200 crore and caused loss of Rs. 14,162 crore (approx.) to its investors so it is also known as India’s Enron.

Initially this IT Company began its services with just 20 employees in Hyderabad in 1987 and grew rapidly as a global business. It offered IT and business process outsourcing services spanning various sectors. Soon it became as an example of India’s growing success. This company also won plentiful awards for innovation, governance, and corporate accountability. In 2007, Ernst & Young awarded Mr.

76. Ahmad Tabrez, Satyam Scam in the Contemporary Corporate World, retrieved from SSRN, i.d. 1460022.
Raju with the ‘Entrepreneur of the Year’ award. On April 14, 2008, Satyam also won awards from MZ Consult’s for being a ‘leader in India in Corporate Governance and accountability’. In September 2008, the World Council for Corporate Governance also awarded Satyam with the ‘Global Peacock Award’ for global excellence in corporate accountability. Unfortunately, less than five months after winning this Award, Satyam became the centerpiece of a massive accounting fraud.

The internal management of the company led by Mr. Raju was able to show the inflated capital which caused the share price of the company to arise from Rs. 138 to Rs. 526 per share in 2008, just 300% improvement of the initial price in five years. After reveal of fraud, the price plummet to just Rs. 11.50 per share on January 11, 2009, which caused huge loss to shareholders.

Mr. Raju disclosed, on January 7, 2009, in a letter to company Board of directors that he had been manipulating the company’s accounting numbers for years. He claimed that he overstated assets on Satyam’s balance sheet by $1.47 billion. Nearly $1.04 billion in bank loans and cash that the company claimed to own was non-existent. Satyam also underreported liabilities on its balance sheet, overstated income nearly every quarter over the course of several years in order to meet analyst expectations. For example, the results announced on October 17, 2009 overstated quarterly revenues by 75 percent and profits by 97 percent.

Mr. Raju and the company’s global head of internal audit used a number of different techniques to perpetrate the fraud using their personal computer. They also created numerous bank statements to advance the fraud. They also falsified the bank accounts to inflate the balance sheet with balances that did not exist. They inflated the income statement by claiming interest income from the fake bank accounts.

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Mr. Raju also revealed that he created 6000 fake salary accounts over the past few years and appropriated the money after the company deposited it. The company’s global head of internal audit created fake customer identities and generated fake invoices against their names to inflate revenue. The global head of internal audit has also forged board resolutions and illegally obtained loans for the company. It also appeared that the cash that the company raised through American Depository Receipts in the United States never made it to the balance sheets.

There were numerous reasons for not detection of fraud committed by Mr. Raju. One of them was lapses by international auditing firm PwC. This audit firm audited the company’s books from June 2000 until the discovery of the fraud in 2009 was criticized callously for failing to detect the fraud. Indeed, PwC signed the company’s financial statements and was responsible for the numbers under the Indian law. The large amount of inflated cash should have been a ‘red-flag’ for the auditors that further verification and testing was necessary. Furthermore, it appears that the auditors did not independently verify with the banks in which Satyam claimed to have deposits. Suspiciously, Satyam also paid PwC twice what other firms would charge for the audit, which raises questions about whether PwC was complicit in the fraud. Furthermore, PwC audited the company for nearly nine years and did not uncover the fraud.

Government of India handled this situation promptly and carefully to protect the interest of the investors and safeguard the credibility of India and the nation’s image across the world. Mr. Raju, Mr. Raju’s brother, B. Ramu Raju, its former managing director, Srinivas Vdlamani, the company’s head of internal audit, and its CFO arrested immediately on various criminal charges of criminal conspiracy, fraud and forgery. Indian authorities also arrested and charged several of the company’s auditors (PwC) with fraud. The Institute of Chartered Accountants of India also ruled that the CFO and the auditor were guilty of professional misconduct. This case was investigated by the SFIO in record three months of time. Mr. Ramalinga Raju along with other 9 person were found guilty and sentenced seven years imprisonment and with fine, by the Hyderabad special Court
on 9th April, 2015 but soon granted bail by the Metropolitan Session Court of Hyderabad on May 11, 2015. Matter is *sub judice*.

There was great relief to Indian capital market when Tech Mahindra purchased 51% of Satyam’s shares on April 16, 2009. This also proved successful saving of the firm from a complete collapse. ICAI found the two PwC auditors prima-facie guilty of professional misconduct. The SFIO, which investigated the Satyam fraud case, also charged the two auditors with “complicity in the commission of the fraud by consciously overlooking the accounting irregularities”.

5.24 CONCLUSION

The audit is intended for the protection of the investors and the auditing is expected to examine the accounts maintained by the directors with a view to inform investors of the true financial position of the company. The investors of the company are mainly depend upon the good faith and efficiency of the auditor appointed to check the accounts and certify the balance sheet of the company, the auditors do have a chance to make a detailed check of the accounts, call for the information and satisfy themselves that the accounts have been properly maintained and the balance sheet are fairly drawn up. The auditors are, therefore, under duty to safeguard the rights of investors *vis-a-vis* the activities of the directors in the purported exercise of their powers in dealing with assets of the company. He is also termed as watchdog. It doesn’t mean that he owes duty only towards the company to which he has been appointed as auditor. He has also ethical duty to report the cases of fraud to concerned authorities promptly in case of detection. He is not expected to be a detective nor is he required to approach his work with a suspicious or pre-conceived impression that there is something wrong. He is watchdog but not a blood hound. However, if there is anything that excites, suspicion in him, he should examine into the matter. But in the absence thereof, he is only required to be reasonably cautious and careful.

Auditors also play a major role in ensuring transparency and accountability in the corporate world, thus they are often called as gatekeepers, eye and ear of the
company. It is also equally true that a fraud may be discovered pertaining to a particular period after the auditor has completed his audit, it does not necessarily mean that the auditor has been negligent or that he has not performed his duties completely. He checks and verifies the books and accounts and vouchers of the company as presented before him. If he has conducted his audit by applying due care and skill in consonance with the accepted professional standards expected, the auditor would not be held responsible for not having discovered that fraud. Therefore it is expected that the auditor should be vigilant in conducting audit of the company.

The shareholders of a company place a very high trust on the auditor’s report, which apparently shows the true and fair view of the accounts of a company. The auditors should perform their duties with utmost care and vigilance to ensure that there are no illegal or improper transactions. It is very important for auditor to use their professional skills and make a reasonable examination of the accounts to see that the dealings are not illegal or improper and it is their duty to uncover such activities. As audit has revealed many corporate frauds in the past so it is an important means to protect the interests of investors.

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