CHAPTER 10

RIGHTS AND DUTIES OF A COMPANY AUDITOR

Rights/Powers of an auditor

10.1 There are various rights conferred upon the auditor by the Companies Act, 2013 (hereinafter referred to as the Act). The principal rights, except those in case of removal of the auditor, are mentioned below:

(i) Right of access at all times to books of account and vouchers of the company

- Section 143(1) confers upon the auditor right of access at all times to books of account and vouchers of the company, whether kept at the registered office of the company or elsewhere.
- The auditor can exercise this right *at all times* which implies normal business hours on any working day.

(ii) Right to obtain information and explanations

- Section 143 empowers the auditor to call for any explanation or information from the employees and officers including managing director and other directors of the company, which he thinks is relevant for the purpose of audit and proper discharge of his duties.
- In case any information or explanation is not given to him, he should mention this fact in his audit report.

(iii) Right of access to records of subsidiaries

- Auditor of a company which is a holding company shall also have the right of access to the records of all its subsidiaries in so far as it relates to the consolidation of its financial statements with that of its subsidiaries

10.2 Duties of Auditor - Section 143, section 144, section 145 and section 146

a. Compliance with audit standard	Every auditor shall comply with auditing standard issued by ICAI. [143(9)]
b. Duty to report fraud	Auditor shall report the material fraud to the Central Government within prescribed time and manner. The same shall not be construed as breach of duty.
c. Duty not to render certain services	According to section 144 of the Act, an auditor can render services as are approved by the BOD or the Audit Committee. He cannot render "consulting and specialized services" which means any one or a combination of - (*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 consultancy services.
d. Duty to sign audit reports, etc. (section 145)	The auditor of the company (in case where auditor is a firm/LLP with CA partners and non-CA partners, only CA partner) shall sign the auditor's report or sign or certify any other document of the company in accordance with the provisions of sub-section (2) of section 141.
e. Duty to attend general Meeting	Under section 146, auditor has a duty to attend any general meeting either by himself or through his authorised representative who is qualified to be an auditor.
f. Duty to report & Duty to enquire	To be discussed in next chapter

10.3 Branch Audit – Section 143(8)

Appointment of an auditor where a branch office of a company is located in India	The accounts of branch office shall be audited ◆ either by the auditor appointed for the company/ company's auditor Or ◆ by any other person qualified for appointment as an auditor and appointed as per the requirements of section 139
Appointment of an auditor where a branch office of a company is located 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
Report of branch auditor to be sent to the company auditor	◆ If the company appoints a branch auditor then 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 a manner as he considers necessary.
Penal provision in case of contravention by the cost auditor	◆ If cost auditor contravenes any of the above mentioned provisions unknowingly then he shall be punishable with fine of Rs. 25,000 to Rs. 5,00,000. ◆ If he contravenes any of the above mentioned provisions knowingly then he shall be punishable with fine of Rs. 1,00,000 to Rs. 25,00,000 along with imprisonment for a term which may extend to 1 year. Further, he shall be liable to refund the remuneration and pay damages to company.

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CHAPTER

LIABILITIES OF AUDITOR

Introduction

12.1 The attest function performed by the auditor has grown immensely in importance in the last century. This has resulted in establishment of legal liability of the auditor not only to the shareholders but also to the third parties. The liabilities of the auditor of a limited company in relation to his work has been expressly mentioned in various statutes including the Companies Act, 1956 and has also been established by pronouncements of the courts.

Classification of liabilities of the auditor

12.2 A plaintiff may bring action against an auditor under common law or statutory law. Liability concepts under common law are developed through court decisions and are based on doctrine of *stare decisis* - handing down precedent setting principles of law to succeeding cases. In contrast, statutory law refers to laws that have been passed by the legislature. Thus, the liabilities of the auditor can be classified as under :

(*i*) Liability under common law

(*a*) Civil liability for negligence towards client

(*b*) Civil liability for negligence towards third parties

(*ii*) Civil and criminal liabilities under statute laws

(*a*) Under the Companies Act, 2013

(*b*) Under the Income-tax Act, 1961

It may be interesting to note that a precise distinction between civil and criminal liability is difficult to draw. Broadly, criminal liability occurs when an act considered to be wrong against society is committed. The offender can be fined or imprisoned or both. Civil liability involves a violation of the rights of some specific party and penalty is in the form of payment of damages.[1]

1. C. William Thomas and Emerson O. Henke, *Auditing Theory and Practice*, Kent Publishing Company, p. 148.

Civil liability under common law

12.3 The client and third parties can sue the auditor for negligent discharge of his duties under common law.

12.3-1 Liability for negligence towards clients -

- WHAT CONSTITUTES 'NEGLIGENCE' - The term 'negligence' describes the failure to exercise reasonable care and skill, which is expected of the auditor, while conducting an audit. Such an expectation stems from the importance of professional services rendered by an auditor to his client. What actually constitutes 'reasonable care and skill' depends upon the circumstances of each case. Generally speaking, he will be made liable for his acts of omission and commission, such as failure to detect defalcations; relying upon certificate as to valuation of stocks given by the management when sufficient grounds were there to arouse auditor's suspicion; payment of dividends out of capital, etc.
- LIABILITY FOR DAMAGES FOR NEGLIGENCE - Even when negligence is proved there is no liability for damages on auditor unless the following conditions are satisfied :
  - (*a*) the auditors owed a duty of care to aggrieved party;
  - (*b*) there has been a failure to conform with the standard of reasonable skill and care as expected from the auditor; and
  - (*c*) the aggrieved party has suffered an actual loss by reason of such negligence.
- LEGAL CASES ON NEGLIGENCE - Some illustrative legal cases in which auditors have been held to be negligent are discussed below—
  - (*a*) *Leeds Estate Building and Investment Company* v. *Shepherd (1887)* - The company was formed to deal in mortgage loans. The articles of association required the dividends to be paid out of profits and remuneration of the directors was to be prorated to dividends. The auditors did not examine the articles and passed the accounts for a number of years which were actually always manipulated. It resulted in payment of remuneration and dividends out of capital and action was brought against the auditors. The Court held that it was the duty of the auditor not to confine himself merely to the task of ascertaining the arithmetical accuracy of the balance sheet but to see that it was a true and accurate representation of the company's affairs. It was no excuse that the auditor had not seen the articles when he knew of their existence.
  - (*b*) *London Oil Storage Co. Ltd.* v. *Seear, Hasluck & Co. (1904)* - The auditor failed to verify the amount of petty cash in hand declared to be £796 in the accounts. The company secretary had misappropriated this amount and only £30 existed in reality. The auditors were found guilty of negligence. It was held that verification of the existence of assets stated in the balance sheet is an important duty of the auditor and accordingly, the auditor should be

held liable for any damage sustained by the company by reason of his failure to verify such assets.

(c) *A.E. Green & Co.* v. *The Central Advance and Discount Corporation Ltd. (1920)* - The auditor relied on information provided by the managing director and failed to draw attention to the fact that the sundry debtors were overvalued. The schedule included statute barred debt besides bad debts. The auditors raised the matter with the managing director but did not report the facts to the directors and shareholders. They were held liable for negligence.

Liability for negligence towards third parties

12.3-2 The liability of an auditor for negligence towards shareholders emanates from his contractual relationship with them. The shareholders appoint him and he submits his report to them. Various interested parties such as creditors, bankers, potential investors, etc. place reliance on auditor's report to take important decisions. His liability in cases of fraudulent misrepresentation resulting in physical injury or financial damage to third parties is well established. However, the liability of the auditor for negligent act or statements has been a matter of controversy. The view taken by the courts[2] have differed from time to time and its evolution can be described in four phases:

- Acceptance of doctrine of privity by courts
- Erosion of doctrine of privity
- Extension of proximity
- Proximity and reasonableness.

(i) ACCEPTANCE OF DOCTRINE OF PRIVITY BY COURTS - The traditional stance of law on the question of liability to third parties was based on the acceptance of doctrine of privity of contract. According to it, an auditor owed a duty of care only to his client with whom he has a contractual relationship. Thus, no third party could hold the auditor responsible in case of negligence. In *Candler* v. *Crane Christmas & Co.* (1951), the plaintiff was induced to invest money in the company on the basis of manipulated accounts. The auditor knew about the reliance being placed by the plaintiff upon the accounts. Subsequently, the plaintiff lost his investment upon the company's liquidation. The court exonerated the auditor by a majority verdict and dismissed the claim of the plaintiff.

(ii) EROSION OF DOCTRINE OF PRIVITY - The erosion of doctrine of privity began with the decision of the highest Court of England, House of Lords, in *Hedley Byrne* case [*see* **Annex 12.1** for facts of the case]. The case involved, not auditors but, a credit report by a bank on which a third party relied and lost its investment. The court, by implication, extended auditor's duty of reasonable care towards a restricted class of third parties such as a bank that has loans outstanding to the client at the balance sheet date.

2. The views stated here have been expressed by courts in Britain and in USA. These have tremendous relevance for the profession all over the world including for India.

This legal view is based upon two principles of law - the doctrine of holding out and the notion of proximity. According to the former, if a person holds out that he possesses certain skills and makes other people rely upon him, he must exercise reasonable care in discharging his duties.

Further, liability of such professional towards third parties can be established on the basis of notion of proximity. If a person is by circumstances placed in a position in relation to another, where his information or advice would be relied upon by the latter, he has a duty to take reasonable care.

(*iii*) THE EXTENSION OF PROXIMITY - The scope of auditor's duty towards third parties was widened in Britain by the Court's decision in *JEB Fasteners Ltd.* v. *Marks Bloom & Co.* [1981]. [For details *see* **Annex 12.1**]. The decision in this case established the proposition that an auditor can be held liable for pecuniary loss caused by his careless auditing of company's accounts to a third party of whose existence even he does not know at the time of audit. The auditors, it was argued, should reasonably have foreseen the possibility of reliance on those accounts by such third parties. Thus, the court recognised the duty of care towards third parties not only on the basis of "proximity" but also on the test of "reasonable foresight".

(*iv*) PROXIMITY AND REASONABLENESS - The decision in *Caparo Industries Plc* v. *Dickman* rejected the concept that damage foreseen was synonymous with proximity. The House of Lords contended that no single general principle can be applied to determine the duty of care of the auditor towards third parties. The judgment made three important principles for imposition of duty of care—

- The damage suffered is the kind of damage which the auditor was under a duty to prevent.
- The auditors knew that the financial statements were being shown/ submitted to the plaintiff for a specific purpose, for example, to induce him to invest money.
- The duty of care extends to the transactions for which the auditors knew their accounts were required, not for subsequent transactions.

Thus, the open-ended liability hinted in *JEB Fasteners* case has been limited by inclusion of the concept of reasonableness of establishing such duties. The decision in *Caparo's* case was to a great extent similiar to the decision in *Hedley Byrne* case.

The decision in *Caparo's* case has become the key case on the issue of auditor's liability for negligence to third parties and has been followed in various courts' judgments. However, it may be noted that, the law relating to liability of an auditor towards third parties is still evolving and the courts may, depending upon the circumstances, take a different view.

Liability under the Companies Act, 2013

12.4-1 Civil liability under the Companies Act

(i) LIABILITY FOR MISSTATEMENTS IN PROSPECTUS - Section 35 lays down the civil liability of promoters, directors and other persons authorising the issue of prospectus including auditors for misstatements in a prospectus. The auditor shall be liable to indemnify the aggrieved party against all damages, costs and expenses incurred by it because of reliance upon such untrue statements. The auditor can escape such liability on the grounds mentioned in this section. These are as follows :—

- He withdrew his consent before the issue of prospectus and it was issued without his authority or constent; or
- the prospectus was issued without his knowledge or consent and that on becoming aware of its issue, he forthwith gave reasonable public notice that it was issued without his knowledge or consent.

(ii) LIABILITY FOR MISFEASANCE - Misfeasance is 'breach of duty or trust'. It is a specific remedy under the Act and can be brought about only when the company is being liquidated. Negligence proceedings under the common law, on the other hand, can be instituted against the auditor at any time. Under section 340 of the Act, the auditor[3] has been held liable for misfeasance in many cases. Some legal decisions on the question of liability of the auditor for misfeasance have been discussed below :

(a) *Re. The London and General Bank Ltd.* [1895] - The bank had advanced loans against insufficient security. No provision for bad debts was created against these loans. The Profit and Loss Account, therefore, did not reflect true profit earned as a result of operations. The auditors pointed out this fact to the directors in a separate report but did not mention anything explicitly about this in the report to the shareholders. The directors paid dividends to the shareholders on the basis of audited Profit and Loss Account and Balance Sheet. As the profits were insufficient, this led to payment of dividends out of capital. The auditors were held liable to make good the company's loss.

(b) *In Re. Kingston Cotton Mills Company Ltd.* [1896] the auditors accepted the certificate of a manager of the company as to valuation of stock-in-trade. The value, as shown by the certificate, was in reality manipulated to inflate the profits. Subsequently, this led to payment of dividends out of capital. The judge exonerated the auditors. It was held that it is not the duty of the auditor to take stock. He is not guilty of breach of duty if he accepts the certificate of a responsible official in this regard provided there is nothing to excite suspicion and he has taken reasonable care.

3. The term 'officer' has been assumed to include auditors for the purposes of this section because of its extensive definition as given by section 2(59) of the Companies Act, 2013.

Modern audit practices have laid down the standards of reasonable care and skill required from the auditors which are more exact and stricter than those prevalent in the nineteenth century. Hence, the views expressed by L.J. LOPES in the above case have not been upheld by the courts recently. The auditor must apply adequate audit procedures to verify stock and not merely rely on a certificate issued by the management.

(c) *Re. The Westminster Road Construction and Engineering Co. Ltd.* [1932] - Work-in-progress disclosed in the balance sheet was overvalued and liabilities were understated through suppressing some invoices for purchases. The auditor relied on the certificate of management as to valuation of work-in-progress and consequently, dividends were paid out of capital. On an application by the liquidator, the Court held the auditor liable to refund to the company the amount of dividends wrongly declared together with interest. It was of the opinion that the auditor had failed in his statutory duty to make specific inquiries as to the existence of liabilities for which invoices might not have been received and to ensure that work-in-progress did not include any item which had actually been received after the finalisation of accounts.

(d) *Irish Woollen Co. Ltd.* v. *Tyson* [1900] - The auditors, under the terms of appointment, were to conduct a monthly audit in the company. These audits failed to disclose the fact that purchase invoices were being fraudulently suppressed. However, the goods were taken into stock and thus, false profits were declared. The court held the auditor liable for misfeasance. LORD JUSTICE HOLMES stated, *"And when no invoices came into the books, it is admitted that this ought to have excited suspicion.............if due care and skill had been exercised..............the suppression of invoices would have been discovered...........the auditor is liable for any damage."*

Criminal liability under the Companies Act

12.4-2 Section 2(59) of the Companies Act, 2013 states:

'Officer' includes any director, manager or key managerial personnel or any person in accordance with whose directions or instructions the board of directors or any one or more of the directors is or are accustomed to act.

Auditor can be regarded as officer[4] of the company for determining his liability under section 34, section 147, section 217, section 342 and section 448. Some of

4. The Supreme Court in *Guru Gobind Basu* v. *Sankari Prasad* [1963] has held that an auditor holds office in a company and accordingly, he is an officer. In various decisions (*Vanguard Fire and General Insurance Co. Ltd., Madras* v. *Fraser; Ross and Inland Revenue Commissioner* v. *Joiner*), it has been held that when a word is defined to 'mean' such and such, the definition is *prima facie* restrictive and exhaustive, whereas where the word defined is declared to 'include' such and such, the definition is *prima facie* extensive (*State of Bombay* v. *Hospital Mazdoor Sabha; Ardeshir H. Bhiwandiwala* v. *State of Bombay*). On this basis, we can conclude that the definition given by section 2(59) is extensive and may include auditors.

the sections of the Act under which he can be held criminally liable are mentioned below:

(*i*) **Section 34 : Misstatements in prospectus** - If a prospectus includes any untrue statement or misstatement, the auditor who authorised the issue of prospectus can be sentenced to imprisonment for a term which may extend to ten years or a fine which shall not be less than the amount involved in fraud and which may extend to three times the amount involved in the fraud (section 447). The auditor can escape liability under this section if he proves—

(*a*) the statement was immaterial; or

(*b*) he had reasonable grounds to believe that the statement was true.

(*ii*) **Section 147 : Penalty for non-compliance by auditor with sections 139,143,144 and 145 -**

According to section 147(2)

- If an auditor of a company contravenes any of the provisions relating to:
  - *a.* Appointment of auditor (section 139)
  - *b.* Contents of audit report (section 143)
  - *c.* Compliance with auditing standards (section 143)
  - *d.* Rendering prohibited services (section 144)
  - *e.* Signing of audit report (section 145)
- The auditor shall be punishable with fine which shall not be less than Rs. 25,000 but which may extend to Rs. 5,00,000.
- If an auditor has contravened such provisions knowingly or wilfully with the intention to deceive the company or its shareholders; or its creditors; or its tax authorities, he shall be punishable with imprisonment for a term which may extend to one year and fine which shall not be less than Rs. 1,00,000 and may extend to Rs.25,00,000.

According to section 147(3)

If an auditor has been convicted of an offence as stated above. He shall be liable to refund the remuneration received by him from the company and pay for damages.

(*iii*) **Section 217 : Production of documents and evidence** - The auditor of a company is required to give assistance to an inspector appointed by the Central Government to investigate the affairs of the company. In case of refusal or failure to produce documents and evidence, an auditor shall be punishable with an imprisonment and fine.

(*iv*) **Section 299 : Power to summon persons suspected of having property of a company, etc.** - During the course of winding up of a company, the National Company Law Tribunal may summon before it auditor if has or is suspected to have possession of any property or books or papers of the company or is capable of giving any material information with regards to the company to the Tribunal. If he fails to appear before the Tribunal, he can be arrested.

(*v*) **Section 342 : Prosecution of delinquent officers and members of the company** - Section 342 deals with the prosecution of delinquent officers and members of the company during the course of voluntary winding up. It lays down the duty of the liquidators and of every officer and agent including auditor to give all possible assistance to the prosecution. In case of failure or neglect in giving assistance, the court can direct such person to comply with the said requirement.

(*vi*) **Section 448 : Penalty for false statements** - If any person deliberately makes a statement in any return, report, certificate, balance sheet, prospectus, statement or other document which is false in any material respect or deliberately omits any material fact, he shall be punishable under section 447.