

B. Com (Hons.) SEM. VI

Paper: Auditing and Corporate Governance

Q.10) What is Audit? what are its objects?

Ans:

* An audit may be said to be such an examination of the books, accounts and vouchers of a business as will enable the auditor to satisfy himself that the Balance sheet is properly drawn up, so as to give a true and fair view of the state of affairs of the business and whether the P&L A/c gives a true and fair view of the profit and loss for the financial period according to the best of his information and the explanation given to him and as shown by the books and if not, in what respect he is not satisfied" — Spicer and Pegler

* "Auditing may be defined as the examination of the books, accounts and vouchers of a business with a view to ascertain whether or not the Balance sheet is properly drawn up so as to show a true and correct view of the state of affairs of the business" — R.G. Williams

* "Auditing may be defined as an intelligent and a critical scrutiny of the books of accounts of a business with documents and vouchers from which they are written up, for the purpose of ascertaining whether the working results for a particular period, as shown by the P&L A/c, as also the exact financial condition of that business, as reflected in the Balance sheet are truly determined and presented by those responsible for their compilation" — J.R. Batliboi

* "An audit is an examination of accounting records undertaken with

a view to establishing whether they correctly and completely reflect the transactions to which they relate. In some instances, it may be necessary to ascertain the whether the transactions themselves are supported by authority" — L.R. Dicksee

* "Auditing in its modern concept is a scientific and systematic examination of books, vouchers and other financial and legal records in order to verify and report upon the facts regarding the financial condition disclosed by the Balance sheet and net income revealed by the Profit and Loss A/c" — Ronald A. Irish

* "Auditing is a systematic examination of the books and records of a business and other organisation, in order to ascertain or verify and to report upon the facts regarding its financial operation and the result thereof" — Montgomery

* "Auditing is a systematic and independent examination of data, statements, records, operations and performances of an enterprise for a stated purpose. In any auditing situation, the auditor perceives and recognises the proposition before him for examination, collects evidence, evaluates the same and on this basis formulates his judgement which is communicated through his audit report" — The ICAI.

Combining all the above definitions, we can define audit with all its requisite elements as an independent and systematic examination of the books, account, records, financial statements and all supporting vouchers and documents of a business or other organisations, for verifying whether

the accounting records truly and properly reflect all the transactions, for the purpose of expressing an opinion in the audit report, to what extent the financial statements give a true and fair view of the state of affairs and of working result of the particular organisation.

-OBJECTS OF AUDITING.

The object of audit depends on the type of audit to be conducted. The detection and prevention of frauds and errors was the primary objective of auditing until the 20th century. The auditors were required to report on whether the financial statements gave a true and fair view of the state of affairs of a business. With increase in size and complexity of the business during the last century, audit evolved into test audits.

In addition to the increased use of testing methods, auditors in order to examine transactions began to secure evidence from 3rd parties such as debtors, banks in case the loan taken by the client etc. They started paying close attention to the valuation and disclosure of broadening assets and liabilities due to rising investor's concern. These developments led to the broadening of audit objectives beyond establishing clerical accuracy and detecting fraud to ascertaining reliability of financial statements. Thus, expression of opinion about the truthfulness and fairness of financial statements became the primary object of an audit and the detection and prevention of frauds and errors was considered to be the secondary object.

(I) PRIMARY OBJECTS:

- Examination of accounting books,
- Verification of financial statements.

II.) SECONDARY OBJECTS:

- Detection of errors,
- Detection of frauds,
- Prevention of errors and frauds,
- Creation of healthy environment,
- Fulfillment of the order of Act,
- To satisfy the Government authorities,
- Advice to the Managers,
- Moral effect on the Employees.

III.) SOCIAL OBJECTS:

- Protection to shareholders,
- To stop evasion of tax,
- To stop capital evasion,
- Measurement of fair wages for labourer,
- Reasonable prices for consumers,
- Fair return and justice to the investors,
- Evaluation of social cost and benefits.

IV.) SPECIFIC OBJECTS:

PRIMARY OBJECTS.

1. EXAMINATION OF ACCOUNTING BOOKS: The main object of audit is to examine accounting books. Here, examination means to compare the records with vouchers on the basis of which records have been made. For every record, there must be voucher. Generally voucher is a written document. As every record must be supported by voucher, in the same way every voucher must be recorded. An auditor has also to see that vouchers are true.

Thus, to examine the accounting books is the primary object of an audit so that the truthfulness of accounting books can be known.

2. VERIFICATION OF FINANCIAL STATEMENTS: The second part of primary object of an audit is to establish, by an examination of books, vouchers and other appropriate records, that the Balance sheet, at a given date, is properly drawn up, so as to show a true and fair view of the state of affairs of the business and the P&L A/c. for the accounting period ended that date also discloses a true and fair view of profit or loss for the period. In order to establish whether the accounts show a true and fair state of affairs, the auditor carries out a process of examination and verification of the accounts. In the process of such an examination of accounts, certain fraud or errors may be detected.

An auditor, in order to satisfy himself about the accuracy of the books of accounts, should examine the following:

- (i) He should examine the system of internal check.
- (ii) He should check the arithmetical accuracy of the books of accounts by the verification of posting, casting and balancing etc.

- (a) Trial Balance should be checked. It is possible that there may be errors in the totalling of the Trial Balance itself.
- (b) List of debtors and creditors should be compared with Trial Balance.
- (c) Verify that no entry of the books of original entry has remained unposted.
- (d) Verify totals of all the books of accounts.
- (e) Check the posting of entries from the various books into the ledger.
- (f) Verify the journal entries. It may happen that the mistakes may be on account of wrong Journal entries.

2. DETECTION OF FRAUDS: Detection of frauds is not the direct responsibility of the auditor and it is not the primary object of audit. Audit does not aim at detection of frauds. If a fraud is suspected, an investigation becomes necessary, which is different from audit. In fact, frauds can be committed in a no. of ways. An auditor must approach his work on the assumption that frauds have been committed. He is only to perform his work with reasonable skill, care and caution. Different types of frauds can be detected by the auditor in the manner given below:

(i) FRAUD INVOLVING MISAPPROPRIATION OF CASH: The debit and audit sides of the cash book have to be carefully vouched and the cash balance at the close of the year should be physically verified. To detect fraud involving receipts, the debit side of the cash book should

- (iii) He should verify the authenticity and validity of transactions entered into the books with the relevant supporting documents.
- (iv) He should confirm the existence and value of assets and to verify liabilities.
- (v) He should ascertain that a proper distinction has been made between items of capital nature and those of a revenue item and that the amounts of various items of income and expenditure correspond to the accounting period.

SECONDARY OBJECTS

1. DETECTION OF ERRORS: Errors are generally committed innocently. But an auditor should be very careful about it, because sometimes errors which might appear as innocent are the results of the fraudulent manipulation. For example, a debtor send ₹ 500. The accountant forgets to make an entry, it is an error. On the other hand, if the accountant intentionally keeps the money with him and spends it for his own use and does not make an entry, it becomes a fraud. Thus an auditor must pay particular attention to it.

(1) LOCATION OF ERRORS: Ordinarily the duty of an auditor is not to trace and locate a difference in the books of A/Cs. He is required to audit the books only, but in many cases, the auditor is frequently called upon to discover the difference in the books of accounts. Such a situation arises only when the accountant is unable to trace it. The auditor should apply the following tests:

be carefully compared with rough cash book, counterfoils of receipts issued, agents and salesmans cash collection statements, and other original records. For discovery of frauds involving payments, the auditor has to carefully check the credit side of cash book and all supporting documents like wage sheets, salary book, counterfoils of cheques, cash memos, receipts, vouchers, etc.

(ii) FRAUDS INVOLVING MISAPPROPRIATION OF GOODS: Frauds involving misappropriation of goods are difficult to detect. Special attention should be given to goods which are costly and less bulky. The internal check system should be examined and records relating to receipts, issue and stock including accounting records of sales, purchases and returns should be examined with the help of basic documents to the extent necessary.

(iii) FRAUDULENT MANIPULATION OF ACCOUNTS: This type of fraud is very difficult to detect, because in most cases, the management remains involved in such frauds and such frauds are dully executed. The auditor has to be very careful in examining the accounts. He should conduct routine checking and vouching with skill and caution, keeping in view correctness of entries passed, correct allocation of expenses and receipts between capital and revenue expenditure. He should see that all adjustments have been rightly passed and provisions have been created in right amounts.

3. PREVENTION OF ERRORS AND FRAUDS: Prevention of errors and frauds is the responsibility of management. By introducing and activating effective internal control, which comprises of internal check and internal audit, the management of an organisation is required to prevent errors and frauds. Audit is not expected to prevent errors and frauds. As a matter of fact, in spite of audit, errors and frauds do occur. But audit definitely casts a moral check on the employees of the organisation. The fact that the accounts will be audited and errors and frauds are likely to be detected, acts as a moral check on the employees and curbs fraudulent intentions. So audit undoubtedly is a preventive check also.

4. CREATION OF HEALTHY ENVIRONMENT: The object of audit is also to create healthy environment in and around the organisation. When employees know that their work and activities are to be examined by some experts, auditors, they become serious towards their duties or work and as a result the possibility of errors and frauds is minimised. Thus, the auditor creates healthy fear psychosis among the employees and accountants so that the environment of honesty, responsibility and truthfulness is created.

5. FULFILLMENT OF THE ORDER OF ACT: An audit also gives emphasis on the fulfillment of the order of Act i.e. the laws under which the company has to work. In certain cases, legal provisions must be faithfully honoured. For example, the Companies Act, 1956 has made compulsory audit of financial accounts of every joint stock company.

6. TO SATISFY THE GOVERNMENT AUTHORITIES: The object of audit is also to satisfy Government authorities in respect of the books of account and the statements prepared by the organisation. The audited statements and accounts are treated to be trustworthy and there is no room left for suspicion about them. Therefore income tax, sales tax and excise duty are computed by the concerned authorities on the basis of these audited accounts. These authorities have to work with the assumption that the accounts and statements prepared by the organisation and audited by an auditor are true and correct.

7. ADVICE TO THE MANAGERS: During the course of audit an auditor comes across with various shortcomings and errors. Hence, it is the auditor's duty that he should give advice to the management regarding these shortcomings and errors. Although it is not the statutory duty of the auditor to provide information to the management but in practice, the auditor gives suggestions regarding important matters to the management.

8. MORAL EFFECT ON THE EMPLOYEES: The work of audit creates fear in the minds of the employees that errors and frauds committed by them would be detected by the auditor which may create adverse situation for them. As a result the employees get morally upgraded and discharge their duties honestly and effectively.

SOCIAL OBJECTS

Any branch of knowledge which directly or indirectly serves the society by rendering their respective services is called social science and therefore, audit also comes within the purview of social science. Naturally, it has got certain social objectives like the objectives of other branches of social science eg. law, government, economics etc. which discharge their respective functions in their related field of operation. The services of an audit are not an exception to it. But the increasing complexities in the world of business arising from technological advances, growing economic and political consciousness, different social reforms, amendment of laws, changing attitude and rising expectations of the general public and investors demand for more dynamic approach in the concept and technique of an audit.

1. PROTECTION TO SHAREHOLDERS : Protection to shareholders mean protection to shareholder's interest in the company. Auditors are the representatives of the shareholders naturally it is the duty of an auditor to see whether the interest of the shareholders is protected or not. The question of protection arise out of the fact that the company is administered by a group of men, called Board of Directors which enjoys majority interest. Since the shareholders are scattered all over the country and who do not take part in management of the company can be classified under 'minority interest group'. So a proper balance between majority and minority groups is required to be maintained. The majority decides the minority. These investors are generally found indifferent to different company meetings and day to day affairs of the company, although the shareholders are empowered to take part.

2: TO STOP EVASION OF TAX: Another vital social object of an audit is to see that the national interest is protected. The national interest can be protected only when cases of evasion of taxes are prevented. There is no denying the fact that raising revenue through taxation is a must for the development of the country and to implement development programmes for the progress of the nation. So, evasion of tax should be discouraged for national interest.

3: TO STOP CAPITAL EROSION: The problem of capital erosion arises when high rate of corporate tax is paid, dividend is paid out of inflated profit and dividends is paid out of unrealised profit etc. It is interesting to note that here the profit of a business inflates due to changing depreciation at Historical cost method and valuation of closing stock at a higher figure. In order to stop capital erosion of the business, which is one of the social objectives of an audit, different systems of audit should be introduced.

4: MEASUREMENT OF FAIR WAGES FOR LABOURER: Measurement of fair wages does not come under the purview of general audit. It should be the social object of an audit to see whether the wages for labourers are fair and in conformity with general price index and to see the basis of measurement for such wages for labourers. It should be the function of an audit to see whether reduction of wages for labourers is made or not in the plea of labour cost control. It is very interesting to note that labour cost control, in its true sense, does not mean payment of wages at a reduced rate and reduction of labourer's wages.

5: REASONABLE PRICES FOR CONSUMERS: It should be the social object of an audit to assess the reasonable price of commodities in relation to individual circumstances and environment of a particular situation. It sometimes happens that the price of an article or a group of articles is changed at a higher figure and excessive discounts are offered for the sale of those articles. This may exploit the sentiments of the consumers. If the prices of articles offered for sale, are initially fixed at a price after deducting high rate discount, the consumer may not be exploited.

6: FAIR RETURN AND JUSTICE TO THE INVESTORS: The fair return of a particular company can be judged with the rate of return of similar type of company or the type of industry which the company belongs to. If the company does not earn fair return, the revenue of the Government may fall. On the other hand, the prospect of business may be withheld. This may result loss of current and future solvency of the business.

7: EVALUATION OF SOCIAL COST AND BENEFIT: This indicates the appraisal of benefits which a business is expected to render for the betterment of society. It should be the social object of an audit to see whether the benefits expected to derive from a business, product line, product design, product design etc. all come within the purview of evaluation of social cost and benefit.

Q.7 Discuss in details the liabilities of a company auditor.

Ans: Statutory audit means an audit which is compulsory by the statute in law. As explained in case of a limited company, audit has been made compulsory by the companies Act, 1956. The Act has made elaborate provisions for qualifications, appointment, rights, duties, immovable and liabilities of an auditor. In case, an auditor fails to discharge his duties, he will be held liable. Broadly speaking, liabilities of a company auditor can be divided as:

i) CIVIL LIABILITIES:

- (a) liabilities of negligence.
- (b) liabilities of misfeasance.

ii) CRIMINAL LIABILITIES:

iii) OTHER LIABILITIES

- (a) liabilities to third parties.
- (b) liabilities of an honorary auditor.
- (c) liabilities for negligence of assistants.
- (d) liability of an auditor for libel.

CIVIL LIABILITIES

A civil liability is that which arises from a civil action for damages and the auditor who is found to have failed in his duty is required to pay damages or compensation as ordered by the court. Civil liabilities have also been classified in two categories:

(a) LIABILITIES FOR NEGLIGENCE:

An auditor is expected to exercise reasonable care and skill while performing his duties. In case he fails to perform his duties with reasonable care, he will be held liable for negligence. This duty of the auditor arises out of the general principles of law. Where a person has undertaken to do a duty under a contract, he must make good (compensate) any loss which the other person suffers due to breach of this duty. By reasonable care is meant, such care and skill which is expected from an average person of his profession. The term 'negligent' has been defined by some judges as follows:

"Negligence includes all such errors, which cause loss to others and the limits of which extends the limits of errors due to lack of skill"
- Prof. Holland -

"Negligence means not taking that much care which the defendant should have taken care off".
- Justice Willes -

Thus negligence means "Acting carelessly or failing to perform a duty enjoined upon a person. It is an act of commission or omission which occurs because the person concerned has failed to exercise the degree of professional care and skill which is expected of him under the circumstances of the case".

TYPES OF NEGLIGENCE AND LEADING CASES REGARDING NEGLIGENCE ON THE PART OF AN AUDITOR:

1) IGNORING ARTICLES AND NOT TO OPPOSE PAYING DIVIDEND OUT OF CAPITAL AMOUNTS TO NEGLIGENCE: In the case of Leeds Estate Building and Investment company vs. Shephard (1957), it was

held that the auditor must see that the Balance sheet is a true and an accurate representation of the company's affairs. The Balance sheet of the company contained fictitious items included with a view to declare more amount of dividend. It was 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 an accurate representation of the company's affairs.

2. NOT ABLE TO DETECT ERRORS AND FRAUDS AMOUNTS TO NEGLIGENCE

In the case of *Irish Wollen Co. vs. Tyson and others (1900)*, the dividend was paid out of capital but the auditor could not find out the fact. Had the auditor conducted the audit of Ledger Accounts with proper care and skill, he could have found out this error. In this case, the auditor was held liable for negligence.

3. NOT VERIFYING PETTY CASH BOOK BALANCE AMOUNTS TO NEGLIGENCE

In the case of *London Oil Storage Co. Ltd. vs. Jeen, Harlock & Co. (1904)* it was held that verification of the existence of assets stated in the Balance Sheet is an important duty of an auditor. The facts of the case were that the auditor did not verify the balance of the petty cash book, which was shown in the Balance Sheet of the company at £ 796 instead of actual balance which was only £ 30. The auditors were found guilty of negligence. Showing of such a large sum as petty cash arouse suspicion and therefore, the auditor should make deeper enquiries.

securities together with accrued thereon interest was in fact bad, but there was no provision for bad debts for the requisite amount. Thus, the P&L A/c. of the company wrongly indicated profit and payment of dividend by the company from such profit results in payment of dividend out of capital.

(ii) PHYSICAL VERIFICATION OF STOCK IS NOT THE DUTY OF AUDITOR

In the case of Kingston Cotton Mills Co. Ltd. (1896), the auditor accepted the stock statement certified by the trusted officers of the company without checking the stock in detail. But, both the quantities and values in the stock statement were intentionally inflated for showing fictitious profit from which dividend would be paid. The auditor certified the Balance sheet with the note 'as per Manager's certificate against stock'. The auditor were charged with misfeasance.

(iii) NOT TO PERFORM THE WORK CAREFULLY AND EFFICIENTLY LEADS TO

MISFEASANCE: In the case of The West Minister Road Construction and Engineering Co. Ltd. (1932), it has been held that an auditor is guilty of negligence in duty amounting to misfeasance, if he fails to detect omission of liabilities from the Balance sheet or over-valuation of work-in-progress, where each is detectable by proper checking. Consequently upon the fact, profit was overstated and distributed as dividend out of capital.

(b) LIABILITIES FOR MISFEASANCE: When an auditor does not perform his duty fully, he can be held liable for breach of the duty and the company can have an action against the auditor. A company auditor who commits a breach of duty or breach of trust will be liable for misfeasance. Under section 543 of the Companies Act, if such breach of has directly resulted in damages to the company. The misfeasance liability under the section arises only in the event of winding-up of a company. As to the section, the court can examine an auditor who is guilty of misfeasance and recover damages from him. An auditor is liable to indemnify only if the following things are proved against him:

- (i) The auditor owed duty to the plaintiff,
- (ii) He failed to discharge his duties and,
- (iii) The plaintiff suffered loss due to non-performance of duty by the auditor.

A case of misfeasance cannot be filed against an auditor during the existence of the company. But when the company is liquidated or under liquidation, the liquidator or shareholders or creditors can file a suit against the auditor.

The leading cases wherein action was instituted against the auditor for misfeasance are listed as follows:

(v) NOT TO GIVE CORRECT INFORMATION TO THE SHAREHOLDERS REGARDING BALANCE SHEET IS MISFEASANCE:

In the case of London and General Bank (1895), the Balance sheet of company did not show the true state of affairs of the company as a large part of advances made by the company against insufficient

CRIMINAL LIABILITIES.

Criminal liabilities are those which arise because of offences against the statutory provisions. These may emerge because of criminal neglect, actual fraud or conspiracy of the auditor. These may emerge due to some criminal acts on the part of auditor or gross neglect of some provisions of the companies Act. In all such cases, the auditor is liable not only to the shareholders but to the state as well. When charged with a criminal liability, an auditor is punishable with fine or imprisonment or both.

The following acts of an auditor are brought under the purview of criminal acts:

- (i) Accepting bribe for discharging his duties.
- (ii) ~~Con~~ Concealing the frauds committed in the account books,
- (iii) Manipulating evidences,
- (iv) Knowingly certifying the false A/c as true one.
- (v) Destroying employer's property.
- (vi) Or giving false evidences.

CRIMINAL LIABILITIES UNDER COMPANIES ACT:

1. FOR MIS-STATEMENT IN PROSPECTUS [Sec. 63]: If a prospectus includes any untrue statement, the auditor who authorised the issue of prospectus can be sentenced to imprisonment for a term which may extend to two years or a fine which may extend to ₹ 50,000 or both. The auditor can escape liability under this section if he proves:

- (i) The statement was immaterial, or
- (ii) He had reasonable grounds to believe that the statement was true.

2. REGARDING FRAUDULENTLY INDUCING A PERSON TO INVEST
[Sec. 68]: If an auditor induces a person to invest in shares or debentures or to sell them or to underwrite by fraudulent method, he may be punished up to 5 years imprisonment or with a fine up to ₹ 1,00,000 or the both.

3. PENALTY FOR NON-COMPLIANCE BY AUDITOR [Sec. 233]: A/c to Section 233, in case of wilful default in making the auditor's report or authenticating or signing a document, the auditor shall be punishable with fine which may extend to ₹ 20,000.

4. FOR NOT RENDERING HELP TO THE INSPECTOR [Sec. 240]: 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 for a term which may be extend to 6 months, or shall be liable to fine which may extend to ₹ 20,000 or both, and also with a further fine upto ₹ 2000 per day for the period till the offence continues after the first day.

LEGAL DECISIONS RELATING TO AUDITOR'S CRIMINAL LIABILITY:

1. DUMBELL BANKING COMPANY LTD. (1900): In this case, the auditor was prosecuted for knowingly suppressing material fact about the financial condition of the company in his report to the shareholders. The Balance sheet of the company contained false information of

overdraft, which was given with the fraudulent purpose of showing the state of affairs of the company much better to the shareholders. The auditor was fully aware of this as his letter to the company's manager so showed. But he made no comment on this in his report to the shareholders. The auditor was, therefore held guilty of deliberate suppression of material information and thereby fraudulently misled the shareholders. He was punished with imprisonment.

2. FARROW'S BANK CASE: (1921): In this case, there had been a considerable writing up of assets, obviously to show more profit available for dividends. For example, a piece of property having cost of 5,500 was written up to 7,80,000. The auditor was convicted on various charges of conspiracy and fraud in connection with the published accounts of the bank, and sentenced to 12 months imprisonment.

3. THE ROYAL MAIL STEAM PACKET CO. LTD. (1930): In this case, the auditor was charged with the offence of aiding and abetting the issue of a false annual report to the shareholders. But the auditor was acquitted of the charge because no deliberate attempt on the part of the auditor to create a false report amounting to fraudulent design was proved against the auditor.

OTHER LIABILITIES.

(i) LIABILITIES TO 3RD PARTIES: The other persons or institutions having dealings with the company are known as 3rd parties. For examples, auditors, bankers, lenders, debentureholders, taxation authorities, investors and other persons etc. An auditor is never appointed by the 3rd party and as such he has nothing to do with such a party. There is virtually no contact between the auditor and 3rd party. An auditor owes no duty towards 3rd parties. He would be liable only when he shall knowingly commit some fraud and due to this, they are put to any loss or damage.

However, the legal position in India on the issue of the liability to an auditor to 3rd parties has changed under section 63(1) of the companies act 1956 subject to the conditions as laid down under sub-section (2) of the said Act. Under the circumstances an auditor can be held liable for the damages to a 3rd party if the auditor had authorised the issue of such prospectus which contains misleading statement. The situation was different prior to the introduction of the Companies Act, 1956.

It can be laid down here that there are no universal and firm norms or principles on the basis of which the liability of an auditor to 3rd parties can be in particular defined or established. However to make an auditor liable for the loss suffered by any 3rd party by relying on his report and taking action thereafter, the following facts can be enunciated.

Under the Chartered Accountants Act, 1949 i.e. he is liable towards this act and its arrangements.

LEGAL DECISIONS.

(a) DERRY VS. PECK (1889)

Case:

- (i) The statement furnished by auditor was untrue.
- (ii) The auditor intentionally behaved to be untruthful.
- (iii) He had given false statement to the 3rd party to encourage them.
- (iv) The 3rd parties had suffered loss due to false statement.

DECISION: The Court had held the auditor responsible to the 3rd parties, if the above mentioned conditions were proved to be true.

(b) LE LIVRE AND DENNIS VS. GOULD (1893):

In the above case, the judge had given the decision that an auditor can be held liable for negligence only when it is proved that the auditor really had duty towards the person charging against him. In the absence of an agreement as such, an auditor has no duty towards the 3rd party and he cannot be charged.

(ii) LIABILITIES OF AN HONORARY AUDITOR:

So far as the liability of an honorary auditor is concerned, he is equally responsible for negligence or misfeasance as a salaried auditor. He cannot be relieved of his liabilities on the ground that the agreement between him and his chief was not supported by consideration.

(i) LIABLE FOR FRAUD: An auditor cannot be held responsible for negligence unless a fraud is established against him. It should be first proved that:

- (i) The statement signed by him was untrue.
- (ii) The person making it knew that it was untrue or was recklessly and consciously ignorant whether it was true or not.
- (iii) The statement was made intentionally for the plaintiff to act.
- (iv) The plaintiff acted in reliance to it and suffered damages.

Thus, in case of fraud in the court of law against the auditor, he can be held liable for damages.

(ii) MORAL LIABILITIES: The work of an auditor is completely a social responsibility. The report prepared by him is relied upon by various classes of people of the society. Thus, auditor has moral liabilities towards the 3rd parties. They make investments in the company and it is the duty of the auditor to prove safety to their investment in the company.

(iii) LIABLE TO HIS EMPLOYEES: An auditor is liable to his auditees in the following circumstances:

- (a) For not being honest (fair dealing) to them,
- (b) For discharging them of their duties without any prior information,
- (c) For non-payment of allowances according to law,
- (d) For not returning premiums received from them.

(iv) LIABLE TO THE INSTITUTE OF CHARTERED ACCOUNTANTS: It is the liability of an auditor to follow the arrangements provided

and hence it was void. He should not undertake the work of auditor if he wishes to be free from any sort of liability with his taking over the responsibility of audit work and submitting his report, he is as responsible for his acts as a paid auditor. On this issue, there is no difference between the two.

LEGAL DECISION

FAIRDEAL CORPORATION, MUMBAI VS. K. GOPAL KRISHNARAO (1957):

In this case, the judge had given the decision that an honorary auditor cannot be relieved of his liabilities of negligence by just saying that he is not paid for his audit work. In this case, the auditor was held responsible for his act of negligence.

(iii) LIABILITIES FOR THE NEGLIGENCE OF ASSISTANTS:

The work of audit is purely based on personal quality of the auditor. This type of work should not be transferred to anybody else. It should be performed by the person concerned himself. Therefore, an auditor should also do his work personally. But, practically it is not possible for any auditor to do all his work personally. He must need a person to assist him and the auditor will be personally liable for the work of his assistant.

(iv) LIABILITY OF AN AUDITOR FOR LIBEL:

In the case of Lawrence vs. Egyptian Cotton & Oil Co it has been decided that, the audit report contains some matter treated to be libel and if so proved, that he included this matter in his report honestly, then he shall not be liable for libel.

Q.6: What are the provisions with regard to appointment and remuneration of an auditor of a company?

Ans: APPOINTMENT OF AUDITOR UNDER COMPANIES ACT, 1956:

Eligibility for appointment of an auditor:

Under section 226 of the Indian Companies Act, 1956, the provisions regarding the eligibility of appointment of an auditor has been laid down. These provisions are applicable to all types of companies, be it a private company, a public limited company, a Government company or a licensed company.

AUDITOR'S QUALIFICATIONS:

The main purpose of section 226(1) and (2) of the Act, is to ensure that only a qualified person possessing the requisite professional knowledge and technical skills is appointed as an auditor. The prescribed qualifications under section 226 are discussed below:

(a) CHARTERED ACCOUNTANT IN PRACTICE: A chartered accountant is a person who is a member of the Institute of the Chartered Accountants of India. Only such person can become member of the Institute who has completed requisite training and passed the examinations prescribed by the Institute. Under the Chartered Accountants Act, the Government of India and the Council of the Institute of Chartered Accountants of India are authorised to recognise any foreign qualifications for the membership of the Institute.

A chartered Accountant can be a practising Chartered Accountant. If a chartered Accountant desires to profess public

practice, he shall be required to obtain a certificate from the Institute and then he is called a Chartered Accountant in practice. Only such a person can be appointed as a company auditor.

(b) PARTNERSHIP FIRM OF CHARTERED ACCOUNTANTS IN PRACTICE

A partnership firm where all the partners practising in India are Chartered Accountants holding certificates of practise, may also be appointed as an auditor of a company. In such a case, the appointment of an auditor may be made in the name of the firm and any partner may act in its name.

(c) CERTIFIED AUDITOR:

A person with a certificate issued before 1951 by any 'B' category state of Indian Union can also be appointed as an auditor of a company registered anywhere in India. Such an auditor is called Certified Auditor. The Central Government has the powers to frame rules providing for grant, renewal, suspension or cancellation of the certificates of the certified auditor.

An auditor of a company can be appointed in different circumstances by the following persons:

- (i) Directors of the company.
- (ii) Shareholders of the company.
- (iii) Central Government.
- (iv) Special Proposal.

APPOINTMENT OF AUDITOR BY DIRECTORS OF THE COMPANY:

1. FIRST AUDITOR: The first auditor of the company is appointed within a month from the date of registration of the company by the Board of directors by a valid resolution. An auditor so appointed shall hold office up to the end of the first Annual General Meeting. If the first auditor is not appointed by the Board of directors, he shall be appointed by the General Meeting of the company.

2. TO FULFILL CASUAL VACANCIES: The directors have been empowered to fill any casual vacancy in the office of the auditor, except one, which is caused by prior resignation of an auditor. Any auditor appointed in a casual vacancy shall hold office until the conclusion of next annual general meeting.

APPOINTMENT OF AUDITOR BY THE SHAREHOLDERS OF COMPANY:

1. FIRST AUDITOR: If the Board of directors of a company do not exercise their powers to appoint the first auditor within the stipulation period, their such rights are forfeited and in that case, the first auditor can be appointed by the general meeting of the shareholders and the auditor so appointed shall continue to act as such till the end of the next annual general meeting. [Sec. 224(5)(B)]

2. CASUAL VACANCY: If a casual vacancy in the office of auditor arises by his resignation, such vacancy should only be filled by the company in a general meeting. In case a casual

vacancy arises because of any other reason except resignation, the shareholders can appoint the auditor only if directors fail to fill the vacancy.

SUBSEQUENT AUDITORS THROUGH ANNUAL APPOINTMENT:

(a) BY ORDINARY RESOLUTIONS: As per provision of section 224(1), subsequent auditors are to be appointed at each annual general meeting by the shareholders by passing a resolution. The tenure of the auditor so appointed would be from the conclusion of that meeting until the conclusion of the next annual general meeting. It is obligatory on the part of the company to inform the appointee of his appointment within 7 days from the date of appointment [Section 224(1)]. The auditor so appointed shall inform in writing to the Registrar to this effect within 30 days from the receipt of the notice of appointment, mentioning whether he has accepted the appointment or not, [Section 224(1)(A)].

(b) BY SPECIAL RESOLUTIONS: In case of certain companies, the auditor is to be appointed only with the approval of the company by a special resolution. Section 224(A) lays down that in case of a company, in which not less than 25% of the subscribed share capital is held, whether singly or in any combination by:

- (i) A Public Financial Institution or a Government Company or Central Government or any state government or,
- (ii) Any Financial or other Institution established by any Provincial or

State Act in which a State-Government holds not less than 51% of the subscribed share capital, or

iii) A nationalised bank or an Insurance company carrying on general insurance business.

The auditor is to be appointed or re-appointed by a special resolution only. The auditor so appointed should also be informed and he should also communicate his acceptance/non-acceptance to the Registrar.

APPOINTMENT OF AUDITOR, BY CENTRAL GOVERNMENT:

1. FIRST AUDITOR: A/c to Indian Company Act, Article 224(3), if the Directors as well as shareholders of the company fail to appoint the auditor within one month of the Company's Registration then the information regarding this fact should be supplied to the Central Government within 7 days of the general meeting failing which the defaulters would be subjected to a fine of ₹ 5000. Having received such information, central government appoints the 1st auditor.

2. ANNUAL APPOINTMENT: If in the general meeting of the company, the retiring auditor has not been replaced by the new auditor its information should be given to the Central Government within 7 days of the meeting so that the Government may take necessary action regarding the auditor's appointment. If the central govt. is not informed about this fact, according to section 619 and 619(B) of the Indian Companies Act, 1956, the Central Govt. should take suggestions from the Controller and Auditor General as regards

the appointment and re-appointment of the auditor.

3. SPECIAL AUDITOR: A/c to Article 233 of the Indian Companies Act, 1956, the central govt has been granted special rights to conduct audit of the books of accounts of the companies under special circumstances. Such auditors present their reports to the Central Government, the copy of which is also sent to the company concerned. The central government may appoint special auditor for a company under the following circumstances:

- (i) If the company is not being managed on the basis of sound principles or prudent commercial practices or,
- (ii) If the company is being run in a way likely to cause serious injury or damage to the industry, trade or business to which the company pertains or,
- (iii) If the financial condition of the company is such as to endanger its solvency.

Only a Chartered Accountant or the company's auditor can be appointed as a special auditor. The duties and rights of a Special auditor shall be the same as of a company auditor except the following differences:

- (i) The Special auditor shall submit his report to the Central Government whereas the company auditor submits his report to the members.
- (ii) His report shall have all such details as that of a company auditor. Nevertheless, he shall include in his report such matters as may be directed by the Central Government.
- (iii) The Central Government may order any person to furnish the

(ii) One basic assumption of this is that where a fixed sum is approved as remuneration of the auditor, it includes his expenses.

(iii) The law, however, does not make it necessary either to specify the amount of remuneration in its general meeting or to fix the remuneration in the same meeting in which the auditor appointed. However the manner in which the remuneration is to be fixed must be laid down in the general meeting.

(iv) In case of re-appointment of an auditor, the existing remuneration will be deemed to be fixed unless a new amount is fixed.

(v) The auditor, besides remuneration for audit work, may also be paid extra remuneration for services rendered in any other capacity and such payment shall be disclosed in the P&L A/C in the manner provided in Part II of schedule VI to the Act and would, thus be classified as:

(a) As auditor,

(b) As adviser, or in any other capacity, in respect of taxation matters, company law matters and management services,

(c) Other amounts paid in any other manner.

2. PAYMENT OF REMUNERATION: Whosoever might have determined the remuneration it shall be paid by the company.

3. LIEN ON THE BOOKS OF ACCOUNTS: If remuneration is not paid to the liquidator he shall not be allowed to keep a lien on the books which shall be returned to the company. He can take resort to the court of law.

special auditors with all information sought by him. Non-compliance of such auditors may render a person liable to a fine which may extend to € 5000.

On receipt of the report from the special auditor, the central government may take such action as it considers necessary in the matter. In case no action is taken within 4 months from the date of receipt of the report, the Government shall send a copy of the report or part thereof with its comments to the company which shall be circulated to the members or read out in the next general meeting. The expenses related to special audit shall be determined by the Central Government and paid by the company.

REMUNERATION OF AN AUDITOR OF A COMPANY:

1. DETERMINATION OF REMUNERATION: Section 224(8) of the Companies Act, provides that the remuneration of an auditor of a company may be fixed by the authority so appointing him. Accordingly, the Board of Directors may fix the remuneration in case of the first auditors or auditors appointed by them to fill a casual vacancy.

When the auditor is appointed by the company at its general meeting, the remuneration shall be fixed by the company at its general meeting.

When the Central Government appoints an auditor, the remuneration may be fixed by it. This is subject to the following explanation:

(i) Section 224(8)(c) provides that any sum paid by the company in respect of the auditor's expense shall be deemed to be included in the remuneration.