

Liabilities of Auditors

Question 1

Indicate the precise nature of auditor's liability in the following situations and support your views with authority, if any:

- (i) A misstatement had occurred in the prospectus issued by the company.
- (ii) Certain weaknesses in the internal control procedure in the payment of wages in a large construction company were noticed by the statutory auditor who in turn brought the same to the knowledge of the Managing Director of the company. In the subsequent year huge defalcation came to the notice of the management. The origin of the same was traced to the earlier year. The management wants to sue the auditor for negligence and also plans to file a complaint with the Institute.
- (iii) Based upon the legal opinion of a leading advocate, X Ltd. made a provision of ₹ 5 crores towards Income Tax liability. The assessing authority has worked out the liability at ₹ 5 crores. It is observed that the opinion of the advocate was inconsistent with legal position with regard to certain revenue items.

Answer

- (i) *Under section 35 of the Companies Act, 2013,*
 - (1) *Where a person has subscribed for securities of a company acting on any statement included, or the inclusion or omission of any matter, in the prospectus which is misleading and has sustained any loss or damage as a consequence thereof, the company and every person who—*
 - (a) *is a director of the company at the time of the issue of the prospectus;*
 - (b) *has authorised himself to be named and is named in the prospectus as a director of the company, or has agreed to become such director, either immediately or after an interval of time;*
 - (c) *is a promoter of the company;*
 - (d) *has authorised the issue of the prospectus; and*
 - (e) *is an expert referred to in sub-section (5) of section 26, shall, without prejudice to any punishment to which any person may be liable under section 36, be liable to pay compensation to every person who has sustained such loss or damage.*

- (2) *No person shall be liable under sub-section (1), if he proves—*
- (a) *that, having consented to become a director of the company, he withdrew his consent before the issue of the prospectus, and that it was issued without his authority or consent, or*
 - (b) *that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave a reasonable public notice that it was issued without his knowledge or consent.*
- (3) *Notwithstanding anything contained in this section, where it is proved that a prospectus has been issued with intent to defraud the applicants for the securities of a company or any other person or for any fraudulent purpose, every person referred to in subsection (1) shall be personally responsible, without any limitation of liability, for all or any of the losses or damages that may have been incurred by any person who subscribed to the securities on the basis of such prospectus.*

Under section 628, an auditor is liable for criminal prosecution, if he, in any return, certificate, balance sheet, prospectus, statement or other document required by or for the purpose of the Act, makes a statement (a) which is false in any material particular knowing it to be false; or (b) which omits any material fact knowing it to be material. If convicted, he can be punished with imprisonment for a term exceeding to two years and also with fine.

- (ii) In the given case, certain weaknesses in the internal control procedure in the payment of wages in a large construction company were noticed by the statutory auditor and brought the same to the knowledge of the Managing Director of the company. In the subsequent year, a huge defalcation took place, the ramification of which stretched to the earlier year. The management of the company desires to sue the statutory auditor for negligence. The precise nature of auditor's liability in the case can be ascertained on the basis of the under noted considerations:
- (a) Whether the defalcation emanated from the weaknesses noticed by the statutory auditor, the information regarding which was passed on to the management; and
 - (b) Whether the statutory auditor properly and adequately extended the audit programme of the previous year having regard to the weaknesses noticed.

SA 265 on "Communicating Deficiencies in Internal Control to Those Charged with Governance and Management" clearly mentions that, "The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies. The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. The auditor shall

also communicate to management at an appropriate level of responsibility on a timely basis". The fact, however, remains that, weaknesses in the design of the internal control system and non-compliance with identified control procedures increase the risk of fraud or error. If circumstances indicate the possible existence of fraud or error, the auditor should consider the potential effect of the suspected fraud or error on the financial information. If the auditor believes the suspected fraud or error could have a material effect on the financial information, he should perform such modified or additional procedures as he determines to be appropriate. Thus, normally speaking, as long as the auditor took due care in performing the audit work, he cannot be held liable.

The fact that the matter was brought to the notice of the managing director may be a good defence for the auditor as well. According to the judgement of the classic case *In re Kingston Cotton Mills Ltd.*, (1896) it is the duty of the auditor to probe into the depth only when his suspicion is aroused. The statutory auditor, by bringing the weakness to the notice of the managing director had alerted the management which is judicially held to be primarily responsible for protection of the assets of the company and can put forth this as defence against any claim arising subsequent to passing of the information to the management. In a similar case *S.P. Catterson & Sons Ltd.* (81 Acct. L. R.68), the auditor was acquitted of the charge.

- (iii) SA 620 on "Using the Work of an Auditor's Expert" discusses the auditor's responsibility in relation to and the procedures the auditor should consider in, using the work of an expert as audit evidence. During the audit, the auditor may seek to obtain, in conjunction with the client or independently, audit evidence in the form of reports, opinions, valuations and statements of an expert, e.g., legal opinions concerning interpretations of agreements, statutes, regulations, notifications, circulars, etc. Before relying on advocate's opinion, the auditor should have seen that opinion given by the expert is *prima facie* dependable. The question states very clearly that the opinion of the advocate was inconsistent with legal position with regard to certain items. It is, perhaps, quite possible that auditor did not seek reasonable assurance as to the appropriateness of the source data, assumptions and methods used by the expert properly.

In fact, SA 620 makes it incumbent upon the part of the auditor to resolve the inconsistency by discussion with the management and the expert. In case, the expert's work does not support the related representation in the financial information the inconsistency in legal opinions could have been detected by the auditor if he had gone through the same. This seems apparent having regard to wide difference in the liability worked out by the assessing authority. Under the circumstance, the auditor should have rejected the opinion and insisted upon making proper provision.

Question 2

You are the auditor of a company, which raised finance from the capital market on the basis of a prospectus issued a few years back. The main object for raising the finance was specified to be setting up a project on information technology.

The company advanced monies so raised to various parties 'related' to directors. These parties had no standing whatsoever with information technology. In the Balance Sheet, these advances appeared as a current asset under the head "loans unsecured – considered good". There was no mention in the notes to accounts about nature and purpose of such advances. You have given routine audit report without any qualifications. One fine morning the directors and these 'related' parties disappear. The company has just vanished.

Can you be hauled up for professional misconduct? Do you have any liability under any law?

Answer

Revised Schedule VI to the Companies Act, 1956 requires specific disclosure of loans granted by the company to its directors or parties such as firms or private companies in which director is a member or a director or a member. Thus, the company has failed to comply with the requirements of schedule VI vitiating true and fair view.

Further, the Companies Act, 1956 specifically deals with transactions in which particular directors are interested. Section 297 specifies that Board's consent is required for certain contracts in which particular directors are interested i.e. a director of the company or his relative, a firm in which such a director or relative is a partner, any other partner in such a firm, or a private company of which the director is a member or director, for the sale, purchase or supply of any goods, materials or services. Section 299 requires disclosure of interest by a director as also lays down the procedure to be followed in this regard. Section 301 of the Companies Act, 1956 requires that every company shall keep one or more registers in which shall be entered separately particulars of all contracts or arrangements to which Section 297 or Section 299 applies, including the following particulars to the extent they are applicable in each case, namely:

- (a) the date of the contract or arrangement;
- (b) the names of the parties thereto;
- (c) the principal terms and conditions thereof;
- (d) in the case of a contract to which Section 297 applies or in the case of a contract or arrangement to which sub-section (2) of Section 299 applies, the date on which it was placed before the Board;
- (e) the names of the directors voting for and against the contract or arrangement and the names of those remaining neutral.

Thus, it is quite natural that all these particulars should have been recorded in such registers since the company advanced monies to various parties "related" to directors.

Still further, CARO, 2003 specifically requires the auditor to comment on the rate of interest and other terms and conditions of loans granted by the company (whether secured or unsecured) to companies, firms or other parties listed in the register maintained under Section 301 of the Act. There may be situations where the company has not properly maintained the register required to be maintained by it under Section 301. In such a case, the auditor should obtain the necessary information regarding the loans taken by the company from companies,

firms or other parties in which the directors are interested, from the management of the company. However, while reporting on this clause, the auditor is required to clearly mention the fact of non-maintenance/improper maintenance of the aforesaid register. The auditor's duty is to determine whether, in his opinion, the rate of interest and other terms and conditions of the loans are prima facie prejudicial to the interest of the company.

The aforesaid provisions aim to prevent siphoning off of funds as also exercise propriety in case of transactions with related parties and disclosure of the same. It appears that the auditor did not perform his duties properly. In the case of Deputy Secretary of the Government of India, Ministry of Finance vs. S.N. Dasgupta, the learned judge made certain observation as regards the duties of the auditor and method they should follow for discharging them satisfactorily and stated that, "verifying not merely the arithmetical accuracy of the statements of account but also their substantial accuracy by confirming that they include all the particulars requiring disclosure by the Articles or the Companies Act and otherwise represents true and fair state of affairs of the company."

Therefore, the auditor has specific obligation to report under the Companies Act, 1956. Thus, he is liable under the Companies Act, 1956 and may be penalised under section 233 since he has performed his duties in a negligent manner. The auditor would also be held liable for professional misconduct under clause 7 of Second Schedule to the Chartered Accountants Act, 1949.

Question 3

Write a short note on - Auditor's liability in case of unlawful acts or defaults by clients.

Answer

Auditor's liability in case of unlawful Acts or defaults by clients: The auditor's basic responsibility is to report whether in his opinion the accounts show a true and fair view and in discharging his responsibility he has to see as to how the particular situations affected his position. The general thinking with regard to unlawful acts or defaults by clients appears to be that the auditor should not 'aid or abet' but he is apparently not under any legal obligation to disclose the offence. A professional accountant would himself be guilty of a criminal offence if he advises his client to commit any criminal offence or helps or encourages in planning or execution of the same or conceals or destroys evidence to obstruct the course of public justice or positively assists his client in evading prosecution. A professional accountant in his capacity as auditor, accountant, or tax representative has access to a variety of information concerning his clients. On some occasions, he may acquire knowledge that his client has been guilty of some unlawful act, default, fraud, or other criminal offence. The duty of the professional accountant in such a case would depend upon the actual circumstances of the situation. Due consideration should be given to the exact nature of services that a professional accountant is rendering to his client, i.e. is he representing the client in income-tax proceedings or is he acting in the capacity of an auditor or an accountant or a consultant.

The Institute of Chartered Accountants of India has considered the role of chartered

accountants in relation to taxation frauds by an assessee and has made the following major recommendations:

- (i) A professional accountant should keep in mind the provisions of Section 126 of the Evidence Act whereby a barrister, an attorney, a pleader or a Vakil is barred from disclosing any communication made to him in the course of and for the purpose of his employment.
- (ii) If the fraud relates to past years when the accountant did not represent the client, the client should be advised to make a disclosure. The accountant should also be careful that the past fraud does not in any way affect the current tax matters.
- (iii) In case of fraud relating to accounts examined and reported upon by the professional accountant himself, he should advise the client to make a complete disclosure. In case the client refuses to do so, the accountant should inform him that he is entitled to dissociate himself from the case and that he would make a report to the authorities that the accounts prepared or examined by him are unreliable on account of certain information obtained later. In making such a report, the contents of the information as such should not be communicated unless the client consents in writing.
- (iv) In case of suppression in current accounts, the client should be asked to make a full disclosure. If he refuses to do so, the accountant should make a complete reservation in his report and should not associate himself with the return.

However, it can be argued that the auditor has a professional obligation to ensure that the client is fully aware of the seriousness of the offence and to seriously consider full disclosure of the matter.

It has been clearly established in various case laws that the auditor is expected to know the contents of documents and records and ascertain whether the affairs of the client are being conducted in an unlawful manner. It is in the course of the work, he comes across any unlawful acts, it is his duty to bring it to the notice of the client as also to make a disclosure in his report in appropriate cases. In this regard, one has to bear in mind the consequence of the act in relation to the professional code to which an auditor is subjected. Under the code, an auditor cannot disclose confidential information unless permitted by the client or unless required by law. Each case has to be judged on its circumstances. However, in every case he has to assess the implications of the unlawful act or default on the true and fair character of the accounting statements.

The question of liability of an auditor for unlawful acts or defaults by clients should be considered in the light of the broad parameters given above. However, it appears that if an auditor was aware of any unlawful act having been committed by client in respect of accounts audited by him and the unlawfulness was not rectified by proper disclosure or any other appropriate means, the auditor owes a duty to make a suitable report. If he does not, he may be held liable, if the true and fair character of the accounts has been vitiated.

Question 4

“Auditor’s liability to third parties in relation to issue of Prospectus”. Discuss.

Answer

Under section 35 of the Companies Act, 2013,

- (1) Where a person has subscribed for securities of a company acting on any statement included, or the inclusion or omission of any matter, in the prospectus which is misleading and has sustained any loss or damage as a consequence thereof, the company and every person who—*
 - (a) is a director of the company at the time of the issue of the prospectus;*
 - (b) has authorized himself to be named and is named in the prospectus as a director of the company, or has agreed to become such director, either immediately or after an interval of time;*
 - (c) is a promoter of the company;*
 - (d) has authorised the issue of the prospectus; and*
 - (e) is an expert referred to in sub-section (5) of section 26, shall, without prejudice to any punishment to which any person may be liable under section 36, be liable to pay compensation to every person who has sustained such loss or damage.*
- (2) No person shall be liable under sub-section (1), if he proves—*
 - (a) that, having consented to become a director of the company, he withdrew his consent before the issue of the prospectus, and that it was issued without his authority or consent; or*
 - (b) that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave a reasonable public notice that it was issued without his knowledge or consent.*
- (3) Notwithstanding anything contained in this section, where it is proved that a prospectus has been issued with intent to defraud the applicants for the securities of a company or any other person or for any fraudulent purpose, every person referred to in subsection (1) shall be personally responsible, without any limitation of liability, for all or any of the losses or damages that may have been incurred by any person who subscribed to the securities on the basis of such prospectus.*

Question 5

Explain briefly duties and responsibilities of an auditor in case of material misstatement resulting from Management Fraud.

Answer

Duties & Responsibilities of an auditor in case of Material misstatement resulting from management fraud: Misstatement in the financial statements can arise from fraud or error. The

term fraud refers to an 'Intentional Act' by one or more individuals among management, those charged with governance. The auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements.

Fraud involving one or more members of management or those charged with the governance is referred to as "management fraud". The primary responsibility for the prevention and detection of fraud rests with those charged with the governance and the management of the entity.

Further an audit conducted in accordance with the standards on auditing generally accepted in India, is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement whether caused by error or fraud. The fact that an audit is carried out may act as deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of financial statements will not be detected, even though the audit is properly planned and performed in accordance with the standards on auditing generally accepted in India. An audit does not guarantee that all material misstatement will be detected because of such factors, as the use of judgment, the use of testing, the inherent limitations of internal control and the fact that much of the evidence available to the auditor is persuasive rather than conclusive in nature.

Certain levels of management may be in a position to override control procedures designed to prevent similar frauds by other employees. Auditor's opinion on the financial statements is based on the concept of obtaining reasonable assurance, hence in an audit, the auditor does not guarantee that material misstatements, will be detected.

Question 6

Explain the liability of the auditor under section 62 of the Companies Act, 1956, for making an untrue statement in the report (as an expert forming a part of the prospectus).

Answer

Under section 35 of the Companies Act, 2013,

- (1) *Where a person has subscribed for securities of a company acting on any statement included, or the inclusion or omission of any matter, in the prospectus which is misleading and has sustained any loss or damage as a consequence thereof, the company and every person who—*
- (a) is a director of the company at the time of the issue of the prospectus;*
 - (b) has authorized himself to be named and is named in the prospectus as a director of the company, or has agreed to become such director, either immediately or after an interval of time;*
 - (c) is a promoter of the company;*
 - (d) has authorised the issue of the prospectus; and*

- (e) *is an expert referred to in sub-section (5) of section 26, shall, without prejudice to any punishment to which any person may be liable under section 36, be liable to pay compensation to every person who has sustained such loss or damage.*
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 - (b) *that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave a reasonable public notice that it was issued without his knowledge or consent.*
- (3) *Notwithstanding anything contained in this section, where it is proved that a prospectus has been issued with intent to defraud the applicants for the securities of a company or any other person or for any fraudulent purpose, every person referred to in subsection (1) shall be personally responsible, without any limitation of liability, for all or any of the losses or damages that may have been incurred by any person who subscribed to the securities on the basis of such prospectus.*