

SCOPE OF AUDIT REPORT UNDER SECTION 227

Sub-sections (2) and (3) of section 227 provide that it is the duty of the auditor to report to the members of the company on the accounts examined by him and on every balance sheet and profit and loss account and every other document declared by the Act to be part of, or annexed to, the balance sheet and the profit and loss account, laid before the company in general meeting during the tenure of his office; also that the report shall confirm the position, envisaged in the under mentioned manner in which the requirements are to be met.

Sub-section (2) specifically requires that the auditor should report whether in his opinion and to the best of his information and according to the explanations given to him, the said accounts give the information required by the Companies Act, 1956, in the manner so required and that the balance sheet gives a true and fair view of the company's affairs at the end of financial year and the profit and loss account gives a true and fair view of the profit or loss for the financial year.

Sub-section (3) requires that the auditor shall report on the following matters:

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

The significance of such a requirement is that the auditor must obtain due satisfaction about the scope of work carried out by him and affirm that in the discharge of his duties he has maintained professional standards of diligence and care.

It should, however, be noted that in the matter of examination of evidence as regards the state of affairs of the company, his duty is limited only to the verification of the evidence that is made available to him in the ordinary course of audit or that which he would call upon to examine on a doubt having arisen that there is something amiss. Suppose, the interest of a director in a transaction, entered into by the company has not been disclosed in the record maintained by the company, as required by section 301 of the Act or the Property Register has not been intentionally produced to prevent detection of the items of plant and machinery that have been given away on loan to a director. In either case, the auditor would not be responsible for failure to track down the frauds, provided during the course of his examination he had asked for the Contract and Property Registers, but the first was incomplete and the existence of the second was denied: provided also that there did not exist any circumstances to arouse his suspicion that some information had been held back deliberately and he had duly reported the violation of the legal requirements.

Justice Lindley in his famous judgment, in the *London and General Bank case*, propounded this view. The relevant passage from the judgment is quoted below:

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

Lopes L. J., held in his judgment in the case of *Kingston Cotton Mills* that auditors must not be made liable for not tracking out ingeniously and carefully laid scheme of fraud when there is nothing to arouse their suspicion and when those frauds have been perpetrated by the tried servants of the company and have been undetected for years by the directors.

Thus, for the collection of information, the auditor is entitled to rely upon trusted servants of the company; he can accept representations made by them either orally or in writing, provided reasonable care is taken to ensure that the data or information furnished are true and could be trusted to have been prepared in the course of the working of the company. If, however, there is any circumstance that should

arouse suspicion, it would be the auditor's duty to probe it to the bottom. So long as there is no such suspicion, he is only expected to exercise normal caution and care.

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

The proper term 'books of account' is defined indirectly under sub-section (1) of section 209 wherein it is stated that a company shall not be deemed to have kept proper books of account in respect of matters specified in sub-sections (1) and (2) of section 209, if there are not kept such books as are necessary to give a true and fair view of the state of affairs of the company or branch office, as the case may be, and to explain its transactions. The Companies (Amendment) Act, 1988 further requires that the proper books of account shall not be deemed to be kept if such books are not kept on accrual basis and according to the double entry system of accounting.

Further, in section 541(2), it is provided that a company that is being wound up shall be deemed not to have maintained proper books of account if it had not kept:

(i) Such books of account as are necessary to exhibit and explain the transactions and financial position of the

business of the company including books containing entries made from day to day in sufficient detail of all cash received and all cash paid; and

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

In the circumstances, proper books of account as required by law are those which contain a record of all the transactions specified both in section 209 and section 541(2) in a manner that they present a true and fair view of the state of affairs of the financial position and profitability of the company.

The cost records prescribed under section 209(1)(d) also form part of books of account required to be maintained under law.

(c) Whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns.

The work of an auditor culminates in the verification of statements of account. It is apparent that the duty, in this regard, would not be properly discharged if he fails to verify them on making a reference to the books of account before

proceeding to make a report thereon. When the auditor reports that proper books of account have been kept and the accounts are in agreement therewith, he confirms that he has discharged the specific duty in this regard imposed on him by the law. If proper books of account have not been kept and if there is a discrepancy in the statements of account and the entries as they appear in the books, he should refer to such a position in his report.

(bb) Whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditor has been forwarded to him as required by section 228(3)(c) and how he has dealt with the same in preparing the auditor's report.

The Research Committee of the Institute has obtained the views of the Counsel on this matter which are reproduced below:

“Having regard to the scheme of sub-section (2), it is clear that though the company in general meeting appoints a branch auditor, the company's auditor still has a certain measure of responsibility in respect of the accounts and papers of the branch. This is shown by the fact that he has a right to visit the branch and has access to the papers and documents of the branch. He must discharge this responsibility by looking into the branch auditor's report and satisfying himself that, having regard to the report and what he has seen of the branch and documents of the

branch, affairs of the branch are in order. It is clear that it would not be enough for him to use in respect of the branch the formula “as he considers necessary” in his report. He is in substance in overall supervision as the company’s auditor and in his capacity he has to make disclosure of anything in regard to the branch which he thinks is not in order and which has come to his notice.”

(d) *Whether in his opinion, the balance sheet and the profit and loss account comply with the accounting standards referred to in sub-section (3c) of section 211 of the Companies Act, 1956.*

(e) In thick type or in italics the observations or comments of the auditors which have any adverse effect on the functioning of the company. This clause requires the auditor to highlight in thick type or in italics the observation or comments which have any adverse effect on the functioning of the company. It may be noted that neither auditor’s observations nor comments have any adverse effect on the functioning of the company. Instead, those observation or comments are about matters which may have an adverse effect on the functioning of the company. The auditor now have to evaluate his qualifications or adverse comments to make judgment as to which of them deal with matters that have an adverse effect on the functioning of the company within the overall context of audit of financial statement of the company.

(f) Whether any director is disqualified from being appointed as director under clause (g) of subsection (1) of section 274."

Clause (f) is required to be read with the provisions relating stated in section 274 (1)(g). Accordingly, the auditor may ensure that certificates are taken from each director are taken on record by the Board to the effect that a director who happens to be on the Board of other companies are not hit by section 274 (1) (g).

The Companies (Second Amendment) Act, 2002 has added Clause (g) in section 227(3), whereby the auditor's report shall have to state whether the cess payable u/s 441A has been paid and if not, the details of the amount of cess not so paid. Section 441A provides for levy and collection of cess on turnover or gross receipt of companies.

Section 211(3A) provides that it is the responsibility of the company to ensure that every profit and loss account and balance sheet of the company shall comply with the accounting standards. In case a company fails to comply with accounting standards, such companies shall disclose in its profit and loss account and balance sheet the deviation from accounting standards, the reasons for such deviation, and the financial effect, if any, arising due to such deviation. Under this sub-clause, a duty has been imposed on auditor to see whether in his opinion, the profit and loss account and balance sheet complied with the accounting standards.

Special requirement in regard to banking, insurance and electricity supply companies - The auditor of a banking company is required by section 30(3) of the Banking Regulation Act also to state the following additional matters viz.,

- (a) Whether or not the information and explanations required by him have been found to be satisfactory;
- (b) Whether or not transactions of the company fall within the powers of a banking company;
- (c) Whether or not the returns received from the branch offices of the company have been found adequate for the purposes of his audit;
- (d) Whether the profit and loss account shows a true balance of profit and loss for the period covered by such account; and
- (e) Any other matter which he considers should be brought home to the shareholders of the company.

Likewise there are special provisions contained in the Insurance Act, 1938 and the Electricity (Supply) Act, 1948 specifying matters on which the auditor should make a report. Similar provisions also are contained in certain other Acts, e.g., Societies Registration Act, 1860. On a consideration of subsections (3), (4) and (5) of section 211, a banking, insurance, electricity supply and other companies governed by the special Acts as well as those which have been specially exempted by the Central Government from making a disclosure of certain matters or from complying

with certain requirements with regard to the balance sheet and profit and loss account, are exempt from drawing up their balance sheet in the form contained in **Schedule VI** to the Act and from furnishing particulars of income and expenditure specified in **Part II** of the Schedule.

The statements of account of the company cannot be deemed to have been improperly drawn up or as not disclosing a true and fair view of the state of affairs of the company merely because they only disclose matters which require disclosure under the special Acts under which they are drawn up or they do not disclose any matter which does not require disclosure by virtue of provisions contained in **Schedule VI** to the Companies Act or any matter which does not have to be disclosed by virtue of notification issued under sub-section (3) or an order issued under sub-section (4) of section 211. It is thus clear that in the statement of account of a company drawn up under the special Acts, only the information requiring disclosure there under needs to be disclosed.

General considerations

The statutory duties of the auditor cannot be limited in any way either by the Articles or by the directors or members but a company may extend them by passing a resolution at the general meeting or making a provision in the articles. [*Newton v. Birmingham Small Arms Co. Ltd.* [1875].

An auditor is expected to determine the scope of his duties on a consideration of the nature of business carried on by the concern, provisions of the law that govern the organization and the system of internal control in operation. Under the **Companies Act**, sub-sections (1A), (2), (3) (4) and (4A) lay down scope of auditor's duties. However, on taking into account the legal decisions in the cases which so far have been taken to courts, his duties and responsibilities can be summarized as follows:

(i) To verify that the statements of account are drawn up on the basis of the books of the business:

The auditor is not responsible for failure to disclose the affairs of the company kept out of the books and concealed from him which could not be known in the ordinary course of exercise of reasonable care and diligence. However, it is his duty to check the books for finding out that the position, as shown by the books of account, is true and substantially correct.

(ii) To verify that the statements of account drawn up on the basis of the books exhibit a true and fair state of affairs of the business:

The duty of the auditor is not limited to mere verification of the arithmetical accuracy of the statements of account. He must find out that these are substantially correct, having regard to provisions in the Articles and the statute governing the business of the organization under which it is being carried on.

(iii) To confirm that the management has not exceeded the financial administrative powers vested in it by the Articles or by any specific resolution of the shareholders recorded at a general meeting

(iv) To investigate matters in regard to which his suspicion is aroused as to the result of a certain action on the part of the servants of the company - He is, however, not required to start an audit with a suspicion or to prove in the manner of trying to detect a fraud or an irregularity unless some information has reached him which excites his suspicion or should arouse suspicion in a professional man of reasonable competence. This is because his duty is verification and not primarily detection of fraud.

(v) To perform his duties by exercising reasonable skill and care - For the verification of matters which are not capable of direct verification, he can rely on what he believes to be honest statements of the management. He must, however, review the verification of assets by the company and not rely merely on the statement made by the persons appointed by the company.

Reporting on matters contained in the Directors' Report - The duty of any auditor for making a report on the statement of account also extends to matters reported upon by the directors to the shareholders in so far as information which is required to be given by the Act in the statements of account or can be given in a statement annexed to the accounts, are contained in the report of directors (Proviso to Section 222). For instance, the opinion of the Board of

Directors as regards current assets, loans and advances, when contained in the directors' report, must be considered by the auditor.