# 2

# AUDIT

## [SECTION 224 TO 233B]

## Law Based Questions

### ■ Qualification and Disqualification ■

**Question 1: Who is disqualified to be statutory auditor of the company.**

**Answer:**

***Qualification***

***(I) An individual -*** *"A person shall not be qualified for appointment as auditor of a company unless he is a chartered accountant within the meaning of the Chartered Accountants Act, 1949".* [Section 226(1)]. It is only a practicing chartered accountant who can be appointed as an auditor of a company.

***(II) Proprietorship firm -*** If a partnership firm of chartered accountant is appointed as auditor, then firm can be appointed as auditor but where the firm is proprietorship firm then the appointment shall be made in the name of its proprietor. A company must appoint the proprietor of the so-called firm by his name in his individual capacity as its auditor and the auditor's report will have to be signed by the proprietor himself in his own name. *Circular No. 8/229/56-PR, dated 20/3/1957.*

***(III) Partnership firm -*** A firm whereof all the partners practicing in India are qualified for appointment as auditor may be appointed by its firm name to be the auditor of the company.

### *Disqualification [Section 226(3)]*

The following entities or persons have been declared disqualified to be appointed as an auditor of a company –

(a) a body corporate;

(b) an officer or employee of the company;

(c) a person who is a partner or who is in the employment of an officer or employee of the company;

(d) a person who is indebted to the company for an amount exceeding Rs. 1000/- or who has given any guarantee or provided any security in connection with the indebtedness of any third person.

(e) A person holding any security of that company after a period of one year from the date of commencement of the Companies (Second Amendment) Act, 2000 i.e. 13.12.2000

*Explanations:* For the purpose of this section, "security" means an instrument which carries voting rights.

(f) a person who by virtue of the above listed provisions is disqualified for appointment as auditor of any other body corporate which is that company's subsidiary or holding company or a subsidiary of that company's holding company or would be so disqualified if the body corporate were a company.

Disqualification may come to an auditor if he ceases to be a member of the Institute of Chartered Accountants of India or is adjudged as having unsound mind or is an undischarged insolvent (vide sections 8 and 20 of the Chartered Accountants Act, 1949).

### *Automatic vacation*

On incurring any of the disqualifications listed above, the office of statutory auditor is deemed to have been vacated. Thus, after appointment as auditor of banking company, if the auditor takes loan from the bank (including any branch of the bank) exceeding Rs. 1000/- he becomes disqualified and has to vacate the office of the auditor in the banking company. Similarly, surrender or cancellation of certificate of practice also results in automatic vacation of office of auditor.

## ■ Appointment and Reappointment ■

**Question 2: How and when statutory auditor is appointed?**

**or**

**Question: How first auditor of the company is appointed and is it possible for the company to appoint first auditor in the general meeting.**

**Answer:**

***(a) Appointment of first auditors [Section 224(5)]***

First auditor or auditors of a company shall be appointed by the Board of directors within one month of the date of registration of the company to hold office until the conclusion of the first annual general meeting. Since the appointment is to be made by the Board specifically, no person can become auditor of the company just by his name being given in the memorandum or articles of the company.

If the Board fails to exercise its duty within the stipulated period, the first auditor can be appointed by the company in a general meeting only.

***(b) Appointment of auditor subsequently [Section 224(1)]***

An auditor shall be appointed in every annual general meeting (AGM) of the company, by passing a resolution only, to hold office from the conclusion of that AGM till the conclusion of the next AGM. If company fails to make appointment of the auditor, as aforesaid, then it is the duty of the company to give an intimation to the Central Government and then the Central Government only can appoint the auditor of the company.

If company fails to give intimation to the Central Government, as aforesaid, then the company and every officer in default shall be punishable with fine extending upto Rs. 5000/-.

***(c) Appointment of auditor for a government company***

According to section 619, the comptroller and auditor general of India appoints the statutory auditor for a government company and remuneration of the auditor is fixed by the company in the general meeting.

***(d) Certificate to be obtained before appointment***

Before any person is appointed as auditor, a certificate shall be obtained from him certifying that if appointed, his appointment will be valid within the meaning of section 224(1B).

**Question 3: Is it necessary to reappoint the retiring statutory auditor?**

**or**

**When it becomes necessary to reappoint a retiring auditor?**

**Answer:** On completion of term of appointment i.e. conclusion of the annual general meeting following the annual general meting in which appointment was made, the auditor retires from the office. A retiring auditor, whether appointed by Board or general meeting, shall be reappointed except where:–

(a) he is not qualified for reappointment.

(b) he has given a notice to the company notice in writing indicating his unwillingness to be reappointed.

(c) a resolution has been passed at that meeting appointing somebody else instead of him or providing expressly that he shall not be reappointed.

(d) a notice has been given of an intended resolution to appoint some person or persons in the place of retiring auditor, and by reason of death, incapacity or disqualification of that person or of all other persons, the resolution cannot be proceeded with.

(e) he holds the audit of specified number of companies or more than that on the day of the appointment in terms of section 224(1B) of the Act.

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**Question 4: When statutory auditor is required to be appointed by passing a special resolution only and what are the consequences if special resolution is not passed?**

**or**

**"Though an Auditor is appointed normally by passing an ordinary resolution, yet there are certain circumstances when appointment can be made only by passing special resolution." Discuss the statement and state the circumstances when passing of special resolution for the appointment of auditor is a must.**

**Answer:**

***Appointment of auditors by special resolution [Section 224A]***

Though ordinarily auditor is appointed by an ordinary resolution but section 224A requires the appointment of auditor to be made by special resolution in the case of a company in which not less than 25% of the subscribed share capital is held whether singly or in any combination, by

(a) a public financial institution or a government company or Central Government or any State Government, or

(b) 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

(c) a nationalised bank or an insurance company carrying on general insurance business.

***Material date***

The material date for the purpose of applicability of provisions of section 224A is the date of the annual general meeting at which the special resolution is required to be passed. *[Circular No. 2/76(1/1/76-CL-V), dated 5/6/1976].* Therefore, if any change has taken place in the shareholding pattern of the company after the issue of notice of annual general meeting the company shall adjourn the meeting to another date, and later issue the required notice in accordance with law and thereafter pass the special resolution required under this section.

***Shareholding as trustee etc.***

Irrespective of the circumstances in which a nationalised bank is holding shares, if the name of the bank is entered in the register of members of the company as holder of shares whether as a trustee or as a secured creditor etc. such holding of shares will have to be taken into account for the purposes of section 224A. *[Circular No. 18/74, dated 12/12/1974]*

***Effect of failure to pass special resolution***

According to Sub-section (2) if auditor is not appointed by a special resolution, as required above, then the auditor will not be deemed to have been appointed and in that case, the appointment of auditor can be made by the Central Government only.

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**Question 5: How a person other than statutory auditor can be appointed as statutory auditor of the company? Write the procedure.**

**Answer:** The retiring auditor shall not be re-appointed where a special notice has been given by any member to the company for appointment of some other person in place of the retiring auditor.

***Serving of copy of notice on the retiring auditor [Section 225(2)]***

Any member can give a special notice to the company at least 14 days before the annual general meeting requiring the company not to reappoint the retiring auditor. Whenever any such notice is received by the company, the company shall immediately send a copy thereof to the retiring auditor. The use of the expressions “shall be required”, “shall forthwith send”, etc., occurring in the said section 225 show that the provisions of the section are mandatory in nature and must therefore be strictly complied with. Contravention of the provision of section 225 would attract penalty to the company under section 629A.

***Effects of not giving copy of notice to the auditor concerned***

If company fails a forward a copy of notice under sub-section (1) to the retiring auditor than such an omission would make the resolution for appointing or removing auditors illegal and ineffective. *Circular No. 35/6/68-CL-III, dated 18/11/1969.* Vide *Circular No. 2/81 [1/1/81-CL-V and 8/20(225)/81-CL-V], dated 17/10/1981* The companies have been advised to forward copy of the special notice to the retiring auditors by the registered AD post.

***Acceptance of office by new auditor***

In this regard it is also to be noted that if the new auditor, being a chartered accountant in practice, accepts the position as auditor previously held by a retiring auditor, being another chartered accountant in practice, without first communication with him in writing, the new auditor shall be deemed to be guilty of professional misconduct as contemplated by clause (8) of the First Schedule to the Chartered Accountants Act, 1949. Finally, if the appointment is accepted by the new auditor, without first ascertaining from the company whether the requirements of section 225 in respect of such appointment had been complied with, that would attract clause (9) of the First Schedule to the Chartered Accountants Act, 1949.

***Rights of retiring auditor [Section 225(2) & (3)]***

The rights given to retiring auditor are to ensure that shareholders get all the relevant information before deciding upon the resolution that the retiring auditor shall not be reappointed or that a person other than the retiring auditor be appointed as auditors are as follows:–

1. Right to make a written representation to the company and request its notification to members of the company.
2. Right to get his representation circulated among the members.
3. Right to get his representation read out at the meeting
4. Right to be heard at the meeting.

***Circulation of written representation made by the auditor***

Where the retiring auditor makes any representations in writing to the company against the special notice and requests its notification to members of the company, the company must, unless the representations are received by it too late for it to do so –

(a) in any notice of the resolution given to members of the company, state the fact of representations having been made;

(b) send a copy of the representations to every member of the company to whom notice of the meeting is sent.

If copy of the representations is not sent as aforesaid because of being received late or because of the company's default, the auditor may require that the representation be read out at the meeting. However, the copies of the representations need not be circulated or read out in the meeting if, on the application of the company or any other aggrieved person, the Central Government is satisfied that the auditor is abusing his right to secure unnecessary publicity for defamatory matters. In such a case, the Central Government may even order that the auditor should meet the company's costs in making the application to the court either fully or partly. [Till now the permission has to be obtained from the Company Law Board instead of Central Government because of non-applicability of the Companies (2nd Amendment) Act, 2002]

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**Question 6: When can the Central Government appoint statutory auditor for the company? Can the central government appoint first statutory auditor of the company?**

**or**

**State the legal position where no auditor was appointed at the annual general meeting of a public limited company.**

**Answer:**

**Appointment of statutory auditor by Central Government**

If at an annual general meeting no auditor or auditors are appointed or re-appointed, the Central Government may appoint a person to fill the vacancy. For this purpose, the company is charged with the responsibility of intimating the above fact to the Central Government within seven days from the date of such meeting.

Here it is to be noted that the Central Government does not have power to appoint first auditor of the company because this power of Central Government is exercisable only where the company fails to make appointment or reappointment at an annual general meeting. **[Section 224(3)]**

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**Question 7: The annual general meeting was adjourned without taking any decision regarding reappointment of the retiring statutory auditor. Can the retiring auditor be deemed to have been reappointed?**

There is no provision under the Act which provides for automatic reappointment of auditor. The auditor cannot be deemed to have been reappointed in any condition because the ***"expression shall be reappointed"*** used under sub-section (2) of section 224 postulates some action on the part of the company resulting in the re-appointment of the retiring auditor. The passing of the resolution for the purpose at the annual general meeting seems essential for the re-appointment of the retiring auditor who is still qualified and willing to act. Till this is done, a retiring auditor cannot be said to have been reappointed as contemplated by the section. *Circular No. 5/72, dated 21/2/1972.*

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## ■ Casual Vacancy ■

**Question 8: What is a casual vacancy in the office of the statutory auditor and how it is filled up?**

**or**

**State the provisions of the Companies Act, 1956 in respect of filling of casual vacancy in the office of auditor.**

**Answer:**

**Casual vacancy in the office of auditor**

A vacancy in the office of auditor, for any reason otherwise than retirement on expiry of term, is referred as Casual Vacancy. If such a casual vacancy arises in the office of auditor due to death, insanity, disqualification or insolvency, etc., but not by resignation, section 224(6) empowers the Board of directors to fill the same. Till the vacancy, so caused, is filled, the remaining auditor or auditors, if any, may act.

Where a casual vacancy results on account of resignation, the vacancy can be filled only in the general meeting. The auditor appointed in a casual vacancy shall hold office until conclusion of the next annual general meeting held after their appointment.

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**Question 9: How will you deal with the appointment of Auditors where one of the partners of a firm of Chartered Accountants appointed as Auditors died. (CA Final, Nov. 1994)**

**Answer:** Where there is a change in the constitution of a firm of Chartered Accountants due to the retirement or death of a partner, the remaining partners can carry on the existing audit assignments standing in the firm's name, provided that the firm continues to be in practice and the companies under audit have the knowledge of the retirement or death of a partner. The firm as such is not dissolved and after reconstitution it continues to carry on its profession in the old name. There is no casual vacancy. As such the question of appointment of new auditors does not arise.

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## ■ Term of office of statutory auditor ■

**Question 10: Discuss provisions related to term of office of the statutory auditor.**

**or**

**Examine with reference with reference to the provisions of the Companies Act – An auditor is appointed to hold office from the conclusion of one annual general meeting till the conclusion of the next annual general meeting. Is he deemed to have vacated office on the date when the meeting is ought to have been held.**

**or**

**Is it in order for an auditor appointed at an annual general meeting to continue to function as auditor when the next annual general meeting has not been held in time? Can he continue as auditors in case a new auditor has been appointed in his place at the annual general meeting which was adjourned to a later date?**

**or**

**Examine with reference with reference to the provisions of the Companies Act – An auditor is appointed to hold office from the conclusion of one annual general meeting till the conclusion of the next annual general meeting. Is he deemed to have vacated office on the date when the meeting is ought to have been held. [CS Inter June 2001, 4 Marks]**

**Answer:**

***Tenure of office of auditor***

The first auditor of the company, whether appointed by the Board or general meeting, shall hold office upto the conclusion of first annual general meeting of the company.

The statutory auditor appointed in the annual general meeting holds office from the conclusion of that annual general meeting till the conclusion of next annual general meting of the company. [section 224(1)]

The tenure of office of the auditor does not expire on the last date on which the annual general meeting was due to be held in terms of Section 166. If annual general meeting of a company is not held for any financial year, the auditor will continue to be in the office until the annual general meeting of the company is properly, called, held and concluded.

***Appointment for duration and not for accounts of a financial year***

The Act does not specify that the auditor shall be appointed for auditing accounts of any particular financial year. Rather, his appointment is for a particular duration. Therefore, he will continue in the office as long as his term does not expire and thus, he will continue to audit the accounts even if such accounts relate to more than one financial year. Further, section 227(2) requires an auditor to report on every balance sheet and the profit & loss account which are laid before the company in general meting during the tenure of his office.

***Intimation of appointment to be given to appointee***

After an auditor or auditors of a company have been appointed, an intimation of such appointment shall be given to him within seven days of the meeting and the auditors so appointed shall also communicate acceptance or refusal to the Registrar, in writing in Form No. 23B of the Companies (Central Government)

General Rules and Forms, 1956, within a period of thirty days of the receipt of intimation of his appointment.

## ■ Removal of auditors ■

**Question 11: State the procedure for removal of auditor before the expiry of his term explaining the relevant provisions of the Companies Act, 1956. [CA Final, May 1999, Nov. 2004, CS Inter June 2000]**

**Answer:**

***Removal of first auditor [Section 225(5)]***

The first auditor(s) may be removed by the company at any general meeting by passing an ordinary resolution provided a special notice in that regard is given to the company. While removing the first auditor, nomination may also be made for appointment of any other person who is otherwise qualified to be appointed as auditor, for being appointed as auditor. Where any person is so nominated, a notice of such nomination shall be given to the members of the company at least 14 days before the date of the meeting.

***Removal of subsequent auditor [Section 224(7)]***

An auditor, except the first auditor, can be removed from the office before the expiry of his term, by passing a resolution in the general meeting after obtaining prior approval of the Central Government.

The company shall immediately provide a copy of the notice to the auditor concerned, preferably by registered post and the auditor will have right to make representation against the notice in writing as well as personally during the meeting.

Any written representation, if received from auditor not less than seven days before the date of the meeting then it shall also be circulated among the members along with the copy of special notice. However, with the prior approval of CLB, the company may avoid circulation of such written representation.

In the general meeting, if resolution for removal is passed, the office of auditor gets vacated and the vacancy can be filled up in the same general meeting if company is having another special notice for nominating another person for appointment otherwise the Board can fill up the vacancy as casual vacancy.

## ■ Restriction on Number of Audits ■

**Question 12: Discuss restriction on number of audits of a chartered accountant.**

**Answer:**

**Ceiling of audits (restriction on number of audits) [Section 224(1B)]**

Section 224(1B) introduces a ceiling on the number of companies of which a firm or a person could be the auditor. Accordingly,

- No company or its Board of Directors shall appoint or reappoint any person or firm as its auditor if such a person or firm is, at the time of appointment or reappointment, holding appointment as an auditor equal to or more than the "specified number" of company as a post of auditor. Here "specified number" means
    - If auditor has all his client companies each of which has a paid up capital less than Rs.25 Lacs twenty such client one can have at a time
    - If auditor has a mix of company clients where some of them are having paid up capital more than or equal to Rs.25 Lacs and some of them having less than Rs.25 lacs than maximum limit is again 20 companies but should be further noted that ot of these 20 companies , not more than 10 may be those whose paid up capital is more than or equal to Rs.25 lacs.

While calculating the number of companies one should keep following additional provisions in mind: -

- In the case of a firm of Chartered Accountants having two or more partners, the specified number shall be counted per partner of the firm. For example if there are three partners, the firm can hold the audit of 60 companies of which not more than 30 companies shall have a paid-up capital of Rs. 25 lakhs or more.
- When one person is a partner in more than one firms, or partner in a firm and also practicing individually, he is allowed to have same 20 audit assignments. In this case he has a choice to divide these 20 assignments into firms, or individually at his will.
- While counting the "specified number", the **audit of a branch** cannot be included as a branch cannot be equated to a full company.
- **Special audits (under section 233 A)** , and audits of **non-corporate bodies** should not be considered for ceiling purposes.

- Audit of **corporations set up under a separate Act** are not to be counted for this purpose.
- **Not for profit making companies** and the companies limited by guarantee are not to be taken into account while computing the specified number.
- **Audit of foreign companies** are excluded from the specified number of 20 company audits.
- **In case of joint audit**, each of the joint auditor should consider a unit at his part for the purpose of calculating the ceiling of audits.
- **Most important to note that after amendment under companies act w.e.f. 13.12.2000 Private companies will also be excluded from the specified limit.**

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**Question 13: Whether an auditor can conduct as many audit as he can of Private companies as they are out of 224(1B)**

**Answer:** No, Although an audit of a private company is excluded while computing the ceiling limit under section 224 (IB) but as per a notification issued by ICAI, a chartered accountant can accept a maximum of 30 audits including the audits of private companies. Non-observance of this ceiling would amount to professional misconduct *[ICAI Notification dated 08.05.2001].*

**Practical Problems on ceiling of audit with harmonious construction of 224(1B) and Notification by ICAI**

| *Types of Companies* | *A* | *B* | *C* | *D* | *E* | *F* |
|---|---|---|---|---|---|---|
| (i) Public Company having paid up capital > 25 lakhs | 6 | 5 | 0 | 10* | 10* | 0 |
| (ii) Other Public Companie | 10 | 5 | 0 | 10 | 0 | 20* |
| (iii) Private Company | 14 | 20 | 30 | 0 | 0 | 0 |
| | 30 | 30 | 30 | 20 | 10 | 20 |

* maximum no. of audits although not touching the threshold of 30.

> **Important Note:** It is important to note that notification of ICAI clearly includes an independent branch audit as a unit count for the purpose of limit of 30 audit assignments. Which seems clearly against appointment of a branch auditor under s. 228 which is not attracted by provisions of 224(1B)

## ■ Remuneration of auditors ■

**Question 14: Discuss provisions relating to remuneration of the statutory auditor.**

**Answer:**

**Remuneration of auditors**

The expression 'remuneration' includes any sums paid by the company in respect of the auditor's expenses in carrying out his duties. Regarding remuneration of auditors, section 224(8) provides as follows:

1. In the case of an auditor appointed by the Board of directors or the Central Government, his remuneration may be fixed by the Board or the Central Government, as the case may be.
2. If the auditor is appointed by the Comptroller and Auditor General of India under section 619 then remuneration shall be decided by the company in the general meeting or in the manner determined by the general meeting;
3. In all other cases, it must be fixed by the company in general meeting or in such a manner as the company in general meeting may determine.

It is to be noted that it is not essential that the remuneration be fixed in the same general meeting in which the auditor is appointed.

An auditor may receive separate remuneration for services rendered other than the audit work, e.g., for advising on taxation matters, writing up the accounts, etc. A separate disclosure of all amounts paid to the auditor in whatever capacity is required to be made in the Profit & Loss Account under Part II of Schedule VI, classified as below:

1. As auditor.
2. As adviser or in any other capacity in respect of:
   (a) taxation matters;
   (b) company law matters; and
   (c) management services; and
3. Other amounts paid in any other manner.

## ■ Rights of the company auditor [Section 227] ■

**Question 15: What are the rights of the statutory auditor?**

**Answer:**

**Rights of the company auditor [Section 227]**

Following are the statutory rights of an auditor these and cannot be limited or abridged either by the Articles or resolution of the members.

***(a) Right of access to books and accounts, etc.***

Every statutory auditor has a right of complete access at all times to the books, accounts and vouchers of the company, wherever kept. The term 'vouchers' includes all documents, correspondence, agreements, etc., which support any of the transactions or data disclosed in the financial statements, directly or indirectly. Similarly, the term 'books' includes the financial, statutory, and statistical books. The phrase 'all times', however, implies only normal business hours.

***(b) Right to obtain information or explanation***

The auditor of a company is entitled "to require from the officers of the company such information and explanations as the auditor may think necessary for the performance of his duties as auditor". Further, Section 221 makes it obligatory for the officers of a company to furnish without delay information sought by the auditor in connection with audit of the company. Any willful failure on the part of any officer is punishable with imprisonment up to six months or a fine up to rupees fifty thousand or with both.

***(c) Right to inspect branch accounts [Section 228]***

If a person, other than the company's auditor, audits accounts of any branch office, the company's auditor shall be entitled to visit the branch office, if he deems it necessary to do so for the performance of his duties as auditor. He shall also have access at all times to the books and accounts and vouchers of the company maintained at the branch office. However, in case of a banking company having a branch office outside India, it shall be sufficient, if the auditor is allowed access to such copies of, and extracts from, the books and accounts of the branch as have been transmitted to the principal office of the company in India.

***(d) Right to receive notices, etc. [Section 231]***

All notices of and other communications relating to, any general meeting of a company, which any member of the company is entitled to receive, shall also be forwarded to the auditor of the company.

***(e) Right to attend general meeting [Section 231]***

Section 231 authorises the auditor to attend any general meeting and be heard thereat, on any part of the business which concerns him as auditor. The auditor may make any statement or explanation with regard to the accounts as he may desire.

***(f) Right to remuneration***

An auditor is entitled to his remuneration on the completion of his work.

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**Question 16: Discuss what are the duties of the statutory auditor?**

**Answer:**

**Duties of statutory auditor**

***(a) Duty to make inquiry under section 227(1A)***

Section 227(1A) requires auditor to make an inquiry in respect of matters specified in that section and to report only where he is not satisfied with the result of his inquiry. The auditor shall inquire–

(a) whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members;

(b) whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company;

(c) where the company is not an investment company within the meaning of section 372 or a banking company, whether so much of the assets of the company as consist of shares, debentures, and other securities have been sold at a price less than that at which they were purchased by the company;

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

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

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

***(b) Duty to make report [Section 227(2)]***

The auditor shall make a report to the members of the company on the accounts examined by him, and on every balance sheet and profit & loss account and on every other document declared by Companies Act to be part of or annexed to the balance sheet or profit & loss account, which are laid before the company in Annual General Meeting during his tenure of office.

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**Question 17: What are the contents of the statutory auditors' report?**

**Answer:**

***Contents of auditor's report***

(a) The report shall state 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 this Act in the manner so required and give a true and fair view –

  (i) in the case of the balance sheet, of the state of company's affairs as at the end of its financial year; and

  (ii) in the case of the profit & loss account, of the profit or loss for its financial year.

(b) The auditor report shall also state –

  (i) whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purposes of his audit;

  (ii) 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 purposes of his audit have been received from branches not visited by him;

  (iii) 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;

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

  (v) Whether the balance sheet and the profit and loss account comply with the accounting standards published under Section 211(3C).

(vi) in thick types or in italics the observations or comments of the auditors which have any adverse effect on the functioning of the company;

(vii) whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274.

(viii) whether the cess payable under section 441A has been paid and if not, the details of the amount of the cess not paid.

Moreover, where matters stated in (i) to (v) are answered in negative or with qualification, the auditor's report shall state the reasons for the answer.

According to sub-section (4A) the Central Government maybe general or special order direct that in case of such class or description of companies as may be specified in the order, the auditor's report shall also include a statement on such matters as may be specified therein.

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**Question 18: When auditors' report is said to be qualified and what is the duty of directors relating to qualified report of the auditors.**

**Answer:** When any of the following subjects is answered in negative in the auditors' report, the report is said to be qualified –

(i) whether he has obtained all the information and explanations which to the best of his knowledge and belief were necessary for the purposes of his audit;

(ii) 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 purposes of his audit have been received from branches not visited by him;

(iii) 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;

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

(v) Whether the balance sheet and the profit and loss account comply with the accounting standards published under Section 211(3C).

***Reasons to be stated for unfavourable or qualified answers***

Where, in the auditor’s report, the answer to any of the questions referred to in paragraph 4 is unfavourable or qualified, the auditor’s report shall also state the reasons for such unfavourable or qualified answer, as the case may be.

Where the auditor is unable to express any opinion in answer to a particular question, his report shall indicate such fact together with the reasons why it is not possible for him to give an answer to such question.

***Duty of directors in respect of qualifications in auditors’ report***

According to section 217(3), if there is any adverse remark in the auditor’s report, the Board shall also be bound to give fullest information and explanations in **its** report or, in cases falling under the proviso to section 222, in an addendum to that report on every reservation, qualification or adverse remark contained in the auditors' report.

According to section 217(4) the addendum to the Directors’ report shall be signed by its chairman if he is authorised in that behalf by the Board; and where he is not so authorised, shall be signed by such number of directors as are required to sign the balance sheet and the profit and loss account of the company under section 215.

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## ■ Liabilities of an Auditor ■

**Question 19: What are the liabilities of statutory auditor?**

**Answer:**

***Civil Liability and relief***

An auditor will be held liable to the company for negligence, if any loss is caused to the company because of the failure of the auditor to perform his duties with reasonable care and skill. However, under section 633, an auditor can seek relief from the Court in respect of any proceedings for negligence, default, breach of duty, misfeasance or breach of trust provided the proceedings are not of criminal nature.

***Criminal Liability***

If the auditor fails to make audit report in accordance with the requirements of the Act, he is liable under criminal law. Criminal liability of an auditor may extend to imprisonment for a period of seven years and/or fine at the discretion of the court.

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**Question 20: What is the liability of an auditor for failure to point out in his report that dividend is paid out of capital? [CA Final, May 2003]**

**Answer:** An auditor who is party to such payment of improper dividend to liable to proceedings by action or in case of winding up, to misfeasance summons and that the improperly paid dividend may be recovered from him with interest.

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**Question 21: Discuss whether internal auditor of the company can be appointed as statutory auditor of the same company.**

**Answer:** A statutory auditor of a company cannot be its internal auditor because of the following reasons --

(a) The statutory auditor is appointed by the company in accordance with the provisions of section 224, and the auditor is required to perform the duties enjoined on him under section 227 and rules/orders issued thereunder.

(b) The internal auditor is appointed by the management and hence is in the position of an employee. Being an officer or employee of the company is a disqualification for auditor under sub-section (3)(b) of section 226.

The auditor is also required to report whether there is adequate internal control procedure commensurate with the size of the company and the nature of its business. If statutory auditor of the company is also the internal auditor, it will not be possible for him to give an independent and objective report under section 227. *Circular No. 29/76[1/1/76-CL-V], dated 27/8/1976 as corrected by Circular No. 5/77[1/1/76-CL-V], dated 8/4/1977.*

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## ■ Audit Committee ■

**Question 22: Discuss provisions of the Companies Act, 1956 relating to Audit Committee.**

**Answer:** According to section 292A, every listed company having paid up share capital of not less than rupees five crores should have an Audit Committee consisting of at least three directors including nominees of public financial institutions, if any. Two-third of the total number of member of the committee shall be other than managing director and whole time director. The constitution of the audit committee shall be disclosed in the annual report.

The members of the committee shall elect one among themselves as the chairman of the committee.

The Audit Committee shall act in accordance with the terms of reference to be specified in writing by the Board. The committee shall have authority to investigate into the matters specified in the section or referred to it by the Board and for that purpose it shall access to all the records maintained by the company.

The committee shall hold periodical discussions with the auditors about internal control systems, the scope of audit including the observations of the auditors and review the half yearly and annual financial statements before submission to the Board.

Any of the recommendations of the committee on matters relating to financial management including the audit report shall be binding on the Board and if the Board does not accept any recommendation of the committee, it shall record the reasons therefore and communicate such reasons to the members.

The auditors, the internal auditor and the director-in-charge of finance shall attend and participate in the meetings of the audit committee but shall not right to vote.

The chairman of the committee shall attend the annual general meeting of the company and provide clarification on matters relating to audit.

If a company, to which provisions of this section are applicable, fails to comply with the requirement of this section, every officer in default shall be punishable with imprisonment upto one year or fine upto Rs. 50,000 or both.

**Question 23: An Audit Committee of a public company constituted under section 292A of the Companies Act, 1956, submitted its report of its recommendations to the Board of Directors. The Board, however, did not accept the recommendations. In the light of the situation analyse whether –**

**(a) The Board is empowered not to accept the recommendations of the Audit Committee.**

**(b) If so, what alternative course of action, the Board would resort to.**

**(c) As a chairman of the Audit Committee how would you respond to the situation?**

**Answer:**

(a) Section 292A provides that any recommendation of the Audit committee on the subject matters related to financial management shall be binding on the Board.

(b) However, if the Board does not accept the recommendations of the Audit Committee, it shall record the reasons in writing and communicate the same to the members.

(c) The Chairman of the Audit Committee shall attend the annual general meeting of the company to provide clarification on any subject matter relating to audit.

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## ■ Special Audit [Section 233A] ■

**Question 24:**

**(i) When Central Government can order Special Audit?**

**(ii) What action can be taken by the Central Government on the basis of report of Special Audit?**

**(iii) Who will pay the fee of auditor for special audit**

**Answer:**

***(i) Power of the Central Government to direct Special Audit***

According to section 233A, the Central Government can make an order for carrying out special audit of a company's accounts for such period as may be specified in the order. Such an order can be made when the Central Government is satisfied that the:

(a) affairs of any company are not being managed in accordance with sound business principles or prudent commercial practices; or
(b) company is being managed in a manner likely to cause serious injury or damage to the interest of the trade, industry or business to which it pertains; or
(c) financial position of any company is such as to endanger its solvency.

The special audit may be carried out by any Chartered Accountant or the Company's own auditor, as may be appointed by the Central Government.

***(ii) Report of Special Audit***

The special auditor shall submit the report of special audit to the Central Government. The report shall contain all matters required to be included in auditor's report under Section 227. If so required by the Central Government, the report shall also include a statement on any matter referred to him by that Government [Section 233A(4)].

On the receipt of the report of special audit the Central Government shall take such action as it may consider necessary within 4 four months since its receipt and if the Government does not take any action on the report within four months from the date of its receipt, a copy thereof shall be sent to the company. While sending the copy of the report to the company, the Central Government may also direct that either copy of report or extracts thereof be circulated to the members or be read at the next general meeting.

***(iii) Expenses of special audit***

All expenses of and incidental to any special audit, including the remuneration of the special auditor, shall be determined by the Central Government and be paid by the company. Section 233A(7)] and in default of such payment it shall be recoverable from the company as arrears of land revenue.

## ■ Cost audit [Section 233B] ■

**Question 25: When is a company required to appoint Cost Auditor? What are his duties and powers? What action can be taken by the Central Government on receipt of Cost Auditor's report?**

**Answer:** Section 233B, sub-section (1) authorises the Central Government to make an order for audit of cost records maintained by a company under clause (d) off sub-section (1) of section 209, in such manner as may be directed by the Central Government.

***(a) Who can carry out cost audit***

The cost auditor shall be a cost accountant within the meaning of the Cost and Works Accountants Act, 1959 (23 of 1959) but, if the Central Government is satisfied that sufficient number of cost accountants are not available for conducting cost audit, it may by a notification authorise cost audit to be conducted by the chartered accountants for such time as may be specified in the notification.

***(b) Disqualification***

A person cannot be appointed as a cost auditor of a company if he attracts any of the disqualification listed in sub sections (3) and (4) of section 226 of the Companies Act, 1956. [Discussed above]. If cost auditor becomes subject to any of the aforesaid disqualification after his appointment, he shall on and from the date on which he becomes so subject, cease to conduct the audit of the cost accounts of the company [Section 233(5)(c)].

Further, a person appointed under section 224 as an auditor of the company shall not be appointed or reappointed for conducting the audit of cost accounts of that company.

***(c) Additional disqualification***

In addition to the aforesaid disqualification the Institute of Cost and Works Accountants of India has notified that any cost accountant who accepts an appointment as the cost auditor of a company in the following situations shall be deemed to be guilty of professional misconduct.

(a) if he is an employee of the company's auditor appointed under section 224;

(b) if he is an employee of any of the partners of a firm of chartered accountants which is appointed as company's auditor under section 224.

***(d) Appointment of cost auditor [Section 233B(2)]***

The Board of Directors of the company shall appoint the cost auditor with the previous approval of the Central Government for which application shall be made in Form No. 23C. Before the Board makes appointment of cost auditor, a written certificate shall be obtained from him to the effect that the appointment, if made, will be in accordance with the provisions of sub-section (1B) of section 224.

The cost auditor, for the purpose of carrying out the audit, will have same powers and duties prescribed under section 227(1) of the Companies Act for the auditors appointed under section 224.

***(e) Appointment of firm of cost accountants as cost auditors***

A firm of cost accountants can also be appointed as cost auditors if all the partners of the firm are practicing cost accountants and the firm itself has been constituted with the previous approval of the Central Government as required under Regulation 113 under the Cost and Works Accountants Act, 1959. In such a case, the cost audit report may be signed by any one of the partners of the firm for and on behalf of the firm. The audit report cannot however be signed merely by affixing the firm's name.

***(f) Ceiling on cost audits***

The ceiling on number of audits as specified under section 224(1B) shall apply to cost audits also. Thus, like a statutory financial auditor, a cost accountant cannot be auditor of more than twenty public companies out of which not more than ten should be companies having a paid-up share capital of Rs. 25 lakhs or more. In case the cost auditor is a partnership firm of cost accountants, the ceiling is twenty companies per partner of the firm.

***(g) Report of cost audit***

The Government has issued Cost Audit (Report) Rules, 2001 specifying the form of the report and the additional information which should be included therein in the form of annexure. The Rules have also set down the various points on which the auditor should make his observations and give his conclusions. The cost auditor shall submit his report to the Central Government and company concerned within 180 days since the end of financial year to which the report relates.

The company shall, within 30 days from the date of the receipt of the copy of the report, furnish the Central Government with full information and explanations on every reservation or qualification contained in such report. [Sub-section (7)].

***(h) Cost audit to be in addition to financial audit***

Cost audit contemplated under section 233B is in addition to the audit conducted by an auditor appointed under section 224 of the Companies Act. Unlike statutory financial audit, cost audit is to be conducted only if the Central Government makes an order for a particular year and for a specified company or specified class of companies. The order for cost audit can be made only in respect of companies engaged in the production, processing, manufacturing or mining activities.

***(i) Cost auditor cannot be internal auditor***

The cost auditor should not be the internal auditor of the company for the period for which he is conducting the cost audit. [Circular No. 1/83 dated 20/01/1983]

# Conceptual Questions

**Question 26: Number of audits of branch offices and audits of foreign company's Indian operations are not to be included within the specified number of companies in which a person can be the auditor. (True/False)**

**Answer:** True. A person is appointed as auditor for auditing branch office under section 228 of the Act and he has to report to the statutory auditors appointed under section 224. Further, language of section 224(1B) puts a limit on the number of companies in which a person can be the auditor and there is no mention of branch audit.

Similarly, section 224(1B) prescribes for the number of audit of companies while foreign companies are not covered under the definition given in section 3 of the Act. Thus, audit of foreign companies will also not be included while counting the number of company audits of person. *Circular No 21 of 1975 dated 24$^{th}$ September, 1975* also confirms the same.

**Question 27: Provisions of Section 224A regarding appointment of auditor by special resolution will not be applicable when the shares are held by nationalised banks in trust. (True/False))**

**Answer:** False. Section 224A does not provide for exceptions to the condition of holding more than 25% of the company's capital. Thus, in whatever circumstances company's shares are held by a nationalised banks, the appointment of the auditor will have to be made by a special resolution if the percentage of such holding in the company's capital exceeds specified percentage. Section 224A requires shareholding, and not the beneficial shareholding.

Central Governments Circular No 18 of 1974 dated 12/12/94 also confirms these views. *"It is clarified that irrespective of the circumstances in which a nationalised bank is holding shares if the name of the bank is entered in the register of the members of the company as holder of the shares, such holding of shares will have to be taken into account, for the purpose of section 224A of the Companies Act, 1956."*

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**Question 28: If shareholding pattern of the company changes after dispatch of notice for the annual general meeting because of which provisions of section 224A are attracted, the appointment of the auditor by an ordinary resolution will be valid. (True/False)**

**Answer:** False. According to section 224A where the shareholding of the specified bodies in the company's paid up capital exceeds 25%, the appointment of company's auditor shall be made by way of special resolution The section is **not very clear** about the time at which the shareholding test is to be applied i.e. at the time of sending notice of AGM or at the time of holding the AGM. In absence of any clarity on the subject, the shareholding test is to be applied at the time of holding the meeting. The Central Government has clarified it vide its circular No 2 of 1976 dated 5$^{th}$ June, 1976.

There may be circumstances where it becomes necessary for a company to appoint the auditor by special resolution because of applicability of the provisions of section 224A while in the notice the appointment of the auditor has been sought by passing an ordinary resolution. In this type of case the company can-not appoint auditor as indicated in the notice and if company does so, provisions of section 224(3) will get attracted. Section 224(3) provides that where no auditor is appointed in the annual general meeting then appointment shall be made by the Central Government.

Thus, the proper course of action for the company in this type of circumstances would be to adjourn the meeting and issue a fresh notice for appointment of the auditor in accordance with the provisions of section 224A.

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**Question 29: The company shall not appoint its cost auditor as its internal auditor. (True/False)**

**Answer:** True. This question has been answered by the Central Government in its circular No 1 of 83 dated 20/1/83 which is reproduced hereunder :

*"A question has been raised whether a cost auditor of a company can also be its internal auditor, which has been carefully examined in this department. Since the cost auditor is required to comment on the scope and performance of internal auditor as per provisions of the Cost Audit (Report) Rules, 1968, it would tend to militate against proper and dispassionate discharge of the duties of the cost auditor. The department, therefore, is of the view that the cost auditor should not also be the internal auditor of a company for which he is concluding the cost audit."*

In addition to aforesaid, the internal auditor is in the capacity of employee of the company and an employee cannot be the cost auditor also.

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**Question 30: The retiring auditor, unless disqualified, get re-appointed automatically. (True / False)**

**Answer:** False. There are no provisions regarding automatic reappointment of retiring auditors. Therefore, retiring auditor can be reappointed only by passing a resolution in the annual general meeting of the company.

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**Question 31: The first auditors may be appointed in the General Meeting. (True / False)**

**Answer:** True. Sub-section (5) of section 224 provides that the first auditor of the company shall be appointed by the Board of Directors within one month of the date of registration of the company and the auditors so appointed shall hold office until the conclusion of the first annual general meeting.

Proviso to Sub-section (5) provides that if the Board fails to exercise its powers regarding appointment of first auditors the auditors may be appointed by the company in the general meeting.

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**Question 32: A vacancy in the office of auditor by resignation can be filled by the Board. (True / False)**

**Answer:** False. Proviso to Sub-section (6)(a) provides that the vacancy in the office of the auditors caused by resignation shall be filled by the company in general meeting only.

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**Question 33: An auditor appointed to fill the casual vacancy holds the office till the day of next Annual General Meeting. (True / False)**

**Answer:** False. The auditors' appointment is made to hold office till the conclusion of annual general meeting to be held after his appointment. Hence an auditor appointed to fill the casual vacancy will not cease to hold office on the day of annual general meeting.

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**Question 34: Removal of auditors from their office prior to expiry of term requires prior approval of the Central Government. (True / False)**

**Answer:** True. Except in the case of first auditor, the auditor can be removed from his office prior to expiry of their term by the company in general meeting only after obtaining prior approval of the Central government. (Section 224(7)).

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**Question 35: Auditors' remuneration has to be decide by the Board of Directors. (True / False)**

**Answer:** False. The auditors' remuneration is decided by the general meeting of the company or it is decided in such manner as may be directed by the company in general meeting (Section 224(8)). Thus, the Board of Directors can fix the auditors' remuneration only if it has been authorised by the company in the general meeting in that behalf.

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**Question 36: Only an individual can be appointed to hold office of the company's statutory auditors. (True / False)**

**Answer:** False. Sub-section (1) of section 226 provides that either an individual who is a qualified Chartered Accountant under the Chartered Accountants Act, 1949 or a firm where all the partners are qualified chartered accountants may be appointed as auditor of the company.

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**Question 37: Director of a company cannot be the auditor of same company. (True / False)**

**Answer:** True. According to section 226 any officer or employee of the company cannot be appointed as statutory auditor of the company. Director is an officer of the company within the meaning of section 2(30). Therefore, Director of a company can not be the auditor of same company.

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**Question 38: If a person who is disqualified for any reason for appointment as company's auditor, he also becomes disqualified for similar appointment in company's holding as well as subsidiary companies also. (True / False)**

**Answer:** True. Sub-section (4) of section 226 provides that a person who is disqualified for appointment as an auditor for any reason provided under sub-section (3), then he shall also be disqualified for similar appointment in any of the company's holding or subsidiary company also.

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**Question 39: An auditor who incurs any disqualification during the term of his appointment, will continue in his office for the term but will not be eligible for further re-appointment. (True / False)**

**Answer:** False. The auditor is deemed to have vacated his office on becoming subject to any of the disqualifications specified under sub-section (3) & (4) of section 226 and, thus, he can-not continue in the office till the expiry of term of his appointment.

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**Question 40: The Company may decide to get the accounts of its branch audited by an independent person who is qualified to be work as auditor. (True / False)**

**Answer:** True. Sub-section (1) of section 228 provides that the accounts of branch of a company shall also be audited by the company's auditor appointed under section 224. However, sub-section (3) authorises the company to decide in general meeting to get the accounts of its branch audited by any other person who is qualified for appointment as auditor.

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**Question 41: The auditors' report shall be read in the annual general meeting by the auditors. (True / False)**

**Answer:** False. Section 230 provides that the report of the auditors' shall be read before the company in general meeting and shall be open to inspection by any member of the company.

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**Question 42: The auditors, not being members of the company are not**

**eligible to attend the annual general meeting of the company. (True / False)**

**Answer:** False. Section 231 of the Act authorises the auditors of the company to attend the general meeting and also for being heard thereat on matters concerning them.

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**Question 43: Where the central government makes an order for cost audit, the appointment of the cost auditor is made by the central government. (True / False)**

**Answer:** False. Sub-section (2) of section 233B provides that the appointment of cost auditor shall be made by the Board of directors of the company with the prior approval of the Central Government.

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# Past Examination Questions

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**Section 224(1)**

**Question 44: Explain the legal position – At an annual general meeting held on 25th September, 1996, the auditor was appointed to hold office up to the conclusion of next annual general meeting. The next AGM was convened on 20th September 1997 but it stood adjourned without transacting any business. Does the retiring auditor continue in the office? [CS Inter June 1999]**

**Answer:** According to section 224(1), the statutory auditor holds office since the conclusion of annual general meeting he is appointed till the conclusion of next annual general meeting. The statutory auditor is not appointed for any particular financial year. Therefore, he will continue in the office until annual general meeting is actually held and concluded. The auditor will continue to audit the accounts even if such accounts relate to more than one financial year. Further, section 227(2) requires an auditor to report on every balance sheet and the profit & loss account which are laid before the company in general meting during the tenure of his office.

In the given case, the statutory auditor appointed on 25th September 1996 will continue to act as statutory auditor of the company until conclusion of the annual general meeting in the calendar year 1997. The facts given in the cases state the annual general meeting held on 20th September 1997 has been adjourned.

Therefore, the office of the existing statutory auditor appointed on 25th September 1996 i.e. the retiring auditor, will continue until the annual general meeting commenced on 20th September 1997 is concluded.

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**Section 224**

**Question 45: ABC Ltd., was registered as a public limited company on 5th May 1988. The first auditor of the company was not appointed within the stipulated time. Advise the company on the steps to be taken mentioning the relevant provisions of the Companies Act, 1956. [CS Inter Dec. 1988, June 2001]**

**Answer:** According to section 224(5), the first auditor or auditors of a company shall be appointed by the Board of directors within one month of the date of registration of the company to hold office until the conclusion of the first annual general meeting. Since the appointment is to be made by the Board specifically, no person can become auditor of the company just by his name being given in the memorandum or articles of the company.

If the Board fails to exercise its duty within the stipulated period, the first auditor can be appointed by the company in a general meeting only.

Applying these provisions in the given case, it can be concluded that where statutory auditor is not appointed by Board within one month since incorporation then auditor can be appointed in the general meeting only.

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**Section 224**

**Question 46: Ram & Company was appointed as auditor of ABC Ltd. at the Annual General Meeting held on 30th September, 2004. Can Ram & Co. continue as auditor of the company in case the next annual general meeting has not been held in time? What would be the position in case the next annual general meeting was held on 30th September, 2005, but adjourned without considering the business of appointment or re-appointment of auditor? (November 2006)**

**Answer**

**Tenure of auditor**

The first auditor of the company, whether appointed by the Board or general meeting, shall hold office upto the conclusion of first annual general meeting of the company.

The statutory auditor appointed in the annual general meeting holds office from the conclusion of that annual general meeting till the conclusion of next annual general meting of the company. [section 224(1)]

The tenure of office of the auditor does not expire on the last date on which the annual general meeting was due to be held in terms of Section 166. If annual general meeting of a company is not held for any financial year, the auditor will continue to be in the office until the annual general meeting of the company is properly, called, held and concluded.

Therefore, Ram & Co. can continue as auditor even if the AGM for the year 2005 has not been held in time. In case AGM for 2005 was held on 30.9.05 that adjourned without considering the business of appointment or reappointment of auditor, the tenure of Ram and Co. will extend till the conclusion of the adjourned meeting.

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**Section 224(1B)**

**Question 47: Mr. Independent who is an individual auditor wants to compute the specified number of audits under the Companies Act, 1956 and for this purpose, he has drawn out a list of which identify, the company which shall be/not be taken into account for the purpose of calculating specified number of audits:**

**(i) Audit of Private Company**

**(ii) Guarantee companies not having share capital**

**(iii) Audit of non-profit companies**

**(iv) Special Audits**

**(v) Audits- of Foreign Companies**

**(vi) Branch Audits**

**(vii) Company audit where he is appointed as a joint auditor**

**Further, he wants to know that as a member of the Institute of Chartered Accountants of India, whether there are any other**

**restrictions on him as a member in the matter of inclusion/ exclusion of audit of private companies for the purpose of calculating specified number of audit assignments. Advice. [RTP June 09]**

**Answer:** In computing the specified number of audits for the purpose of Section 224(1B), the following audit shall not be taken into account:

(a) Audit of private company.

(b) Audit of Guarantee Companies not having share capital.

(c) Special Audits.

(d) Audit of Foreign Companies.

(e) Branch Audits.

Though the audit of private companies has been excluded for the purpose of calculating the specified number of audits, as a member of Institute of Chartered Accountants of India, the Audit of Private Companies will come under the purview of calculating the ceiling limit as a matter of self-regulation.

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## Section 224 and 225

**Question 48: State the procedure for the following, explaining the relevant provisions of the Companies Act, 1956:**

**(i) Appointment of First Auditor, when the Board of Directors did not appoint the First Auditor within one month from the date of registration of the company.**

**(ii) Removal of Statutory Auditor (appointed in last Annual General Meeting) before the expiry of his term.**

**What difference it would make, if the Auditor was First Auditor appointed by the Board of Directors? (November, 2004)**

**Answer**

**(i)** According to Section 224(5) of the Companies Act, 1956 First auditor or auditors of a company shall be appointed by the Board of directors within one month of the date of registration of the company to hold office until the conclusion of the first annual general meeting. Since the appointment is to be made by the Board specifically, no person can become auditor of the company just by his name being given in the memorandum or articles of the company.

If the Board fails to exercise its duty within the stipulated period, the first auditor can be appointed by the company in a general meeting only.

**(ii)** According to section 225(5), the first auditor(s) may be removed by the company at any general meeting by passing an ordinary resolution provided a special notice in that regard is given to the company. While removing the first auditor, nomination may also be made for appointment of any other person who is otherwise qualified to be appointed as auditor, for being appointed as auditor. Where any person is so nominated, a notice of such nomination shall be given to the members of the company at least 14 days before the date of the meeting.

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**Section 224A**

**Question 49: A Government company holds 49% of the subscribed share capital in Smart & Co. Ltd. Mr. R has been appointed as the auditor at the Annual General Meeting of Smart & Co. Ltd through an ordinary resolution. Certain members of the company object to this appointment on the ground that the appointment of auditors is violative of the provisions of the Companies Act, 1956. Examine the legal position with reference to the relevant provisions of the Companies Act, 1956. [Nov. 08]**

**Answer:**

***Appointment of auditors by special resolution [Section 224A]***

Though ordinarily auditor is appointed by an ordinary resolution but section 224A requires the appointment of auditor to be made by special resolution in the case of a company in which not less than 25% of the subscribed share capital is held whether singly or in any combination, by –

(a) a public financial institution or a government company or Central Government or any State Government, or

(b) 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

(c) a nationalised bank or an insurance company carrying on general insurance business.

***Effect of failure to pass special resolution***

According to Sub-section (2) if auditor is not appointed by a special resolution, as required above, then the auditor will not be deemed to have been appointed and in that case, the appointment of auditor can be made by the Central Government only.

Hence in the given problem, it shall be deemed that Mr. R had not been appointed as Auditor of Smart & Co. Ltd. because the company had not passed special resolution in the Annual General Meeting for appointment of Mr. R as auditor of the company.

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**Section 226**

**Question 50: Amol & Co., a proprietary firm of Amol, a chartered accountant in practice, has been appointed as statutory auditors for a private limited company. Subsequently it came to the light that Mrs. Amol has been holding less than 1% of the shares of that company. Will this vitiate the appointment of the statutory auditors. Answer with reason. [CS Inter June 2005]**

**Answer:** According to section 226(3), any person holding any security in the company carrying voting right is disqualified to be appointed as statutory auditor of the company.

In the given case, a proprietary firm i.e. Amol & Co. has been appointed as statutory auditor of a private company in which Mrs. Amol is holding shares. Since Mr. Amol himself is not holding shares in the company, his appointment as statutory auditor of the will not be vitiated when it comes to the knowledge that Mrs. Amol is holding shares in the company.

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**Section 226**

**Question 51: Can an auditor be disqualified for indebtedness in the following cases?**

**(a) Where he is recovering his fees on a progressive basis even though the job is not complete.**

**(b) Where the auditor's firm has purchased goods from the auditee company and not paid for them for over six months. [CA Final, Nov. 1998, May 2003]**

**Answer**: (a) In order to ensure independence of auditors, the Companies Act, 1956 has made certain provisions which either prohibits the appointment of a person as auditor in certain circumstances or place certain restrictions on the appointment as auditor or put third parties on guard against the possibility of an abridgment of independence by requiring certain disclosures to be made. As per section 226(3)(d), a chartered accountant cannot be appointed as an auditor of the company, if he is indebted to the company for an amount exceeding Rs. 1,000. In this connection, a question often arises as to whether an indebtedness [as referred in [Section 226(3)(d)] arises in cases where in accordance with the term of his engagement by a client (e.g. resolution passed at the general meeting) the auditor recovers his fees on a progressive basis, and when a part of the work is done without waiting for the completion of the whole job. In these circumstances, where in accordance with such terms, the auditor recovers his fees on a progressive basis he cannot be said to be indebted to the company at any stage. (ICAI Guidance Note on Independence of Auditors).

(ii) According to section 226(3)(d) *"a person who is indebted to the company for an amount exceeding Rs. 1000/- or who has given any guarantee or provided any security in connection with the indebtedness of any third person."* In this clause, there is no specification regarding the debt outstanding. Therefore, where the auditor firm has purchased goods from the auditee company and payment has not been made for last six months, it is a debt outstanding.

The given question is silent regarding the amount outstanding. Therefore, it is not possible to decide whether the auditor firm is disqualified or not.

(a) if the amount outstanding does not exceed Rs. 1000/- the firm is not disqualified.

If the amount outstanding is exceeding Rs. 1000/-, the firm as well as every partner of such firm becomes disqualified.

There may also be situations in which, though the appointment is in the individual name of a partner, the work, is in fact, carried out by the firm and the fees are credited to the account of the firm. In such situations, the firm will be deemed to be acting, as auditor and the disqualification will be attracted.

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**<u>Section 226</u>**

**Question 52: One of the members of ADB Ltd. has proposed the name of Mr. Fame for appointment as a Director of the Company in the Annual General Meeting and given a notice under Section**

**257 of the Companies Act, 1956. Mr. Fame is one of the partners of the Fame & Fame, Chartered Accountants, who are the retiring auditors of the company. But the audit of the company is being looked after by another partner of the firm. Examine whether Fame & Fame can be reappointed as auditors, if Mr. Fame is appointed as Director. (May 2006)**

**Answer:** According to section 226(3)(b) and (c), the following entities or persons have been declared disqualified to be appointed as an auditor of a company –

(b) an officer or employee of the company;

(c) a person who is a partner or who is in the employment of an officer or employee of the company;

Within the meaning of section 2(30), of the Act, director is an officer of the employee. Section 2(30) and Section 226(3)(b) and (c) read together indicate that if Mr. Fame is appointed as director of the company then the firm where he is a partner i.e. Fame and Fame, cannot be appointed as statutory auditor of the company.

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**Section 227**

**Question 53: The auditors of PQR Ltd. accepted the Certificate of the Manager, a person of acknowledge competence and high reputation, as to the value of the stock in trade. The stock was grossly overstated for several years in the balance sheets of the company. As a result of this over valuation dividends were paid out of capital. The Auditors did not examine the books of account very minutely. If they had done so and compared the amount of stock at the beginning of the year with the purchases and sales during the year, they would have noticed the over valuation. The company subsequently went into liquidation and the auditors were sued to make good the loss caused by the wrongful payment of dividends relying on the balance sheets figures. Based on the above facts, you are required to decide. With reference to the provisions of the Companies Act, 1956 and the decided case laws, the following issues:**

**(i) Whether auditors of the company will be liable for the loss caused to the company by the wrongful payment of dividends based on the Balance Sheets duly audited by the Auditors.**

**(ii) What are the statutory duties of the Auditors in this regard ? [Nov. 07]**

**Answer:** The given question relates to the duties of the auditors. According to Section 227 of the Companies Act, 1956 the main duty of the auditor is to make a report to the members of the company on the accounts examined by him and the balance sheet and the profit and loss account of the company and on every document which is annexed to the balance sheet or profit and loss account laid before the company in general meeting. The auditor owes a duty to the members to state whether the accounts give a true and fair view of the affairs of the company at the end of the financial year and of the profit and loss account of the year.

During the course of audit, if auditor discovers any illegal or improper payment having been made, he shall report it to the members. The auditor occupies a fiduciary position in relation to the members. While auditing the accounts he must act in the best interest of the shareholders who are in the position of beneficiaries.

It is also to be noted that the auditor should not act a detective. He should not approach his work with suspicion or with a foregone conclusion that there is something wrong. To a certain extent he is justified in believing the employees of the company in whom confidence is placed by the company. He is entitled to assume that they are honest and to rely upon their representations, provided he takes reasonable care. If there is anything calculated to excite suspicion, he should probe it to the bottom, but in the absence of any thing of that kind he is only bound to be reasonably cautious and careful. The above problem is related to case of *Kingston Mill Co. Re (No 2) (1896) 2 ch 279.* In this case it was held that, the auditors were not liable. It is not auditor's duty to take valuation of the stocks. There are many matters in which he may rely on the honesty and accuracy of others. Further they (auditors) do not guarantee the discovery of all frauds.

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**Section 227**

**Question 54: State the requirements under the Companies Act with regards to compliance of accounting standards and the disclosure to be made in case the profit and loss account and the Balance Sheet of the company do not comply with the accounting standards. What is the duty of the auditor of the company in this regard? [CA Final, May 2000]**

**Answer: According to section 211** it compulsory for profit and loss account and balance sheet of all companies to comply with the accounting standards recommended by the Institute of Chartered Accountants of India (ICAI) and prescribed by the Central Government in consultation with National Advisory Committee on Accounting Standards. So long such accounting standards are not prescribed by the Central Government, the standard of accounting specified by the ICAI will be deemed to be the Accounting Standards [Section 211(3C)]

Section 211 (3B) also provides for compulsory disclosure by all companies in their profit and loss account and balance sheet, the deviation from the accounting standards, if any, and its reasons with the financial effect, if any arising due to such deviation.

According to Section 227 it obligatory on the part of the auditors of the company to include a Para in their report to the members of the company, stating whether in their opinion the profit ands loss account and the balance sheet comply with the accounting standards referred to in Sub-section (3C) of Section 211. In case of non-compliance of accounting standard, the auditors are required to qualify their report.

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**Section 233A**

**Question 55: A group of shareholders approaches you for advice regarding the affairs of Aggressive Textiles Ltd. According to the shareholders, the management of the company is not exercising its powers properly and that a special audit should be conducted so that the real nature of transaction carried out by the management will come to light. Advise, with reference to the provisions of the Companies Act, as to when a special audit can be directed and by whom. [CA Final, May 2001]]**

**or**

**A group of shareholders has approached you for advice regarding the affairs of LPM Paper Mills Ltd. According to them, the management of the company is not carrying out its functions in accordance with the prudent commercial practice and if the affairs of the company are allowed to run in future in the same manner, the company's solvency would be in danger. They want that a Special Audit be conducted to find out the actual nature of the transactions.**

**(i) You are required to state with reference to the provisions of the Companies Act, 1956, as to when a special audit can be directed and by whom.**

**(ii) Draft an application to be submitted to the appropriate authority in this respect. (November 2006, May 08)**

**Answer**

**(i)** According to section 233A, the Central Government can make an order for carrying out special audit of a company's accounts for such period as may be specified in the order. Such an order can be made when the Central Government is satisfied that the:

(a) affairs of any company are not being managed in accordance with sound business principles or prudent commercial practices; or

(b) company is being managed in a manner likely to cause serious injury or damage to the interest of the trade, industry or business to which it pertains; or

(c) financial position of any company is such as to endanger its solvency.

Thus, the group of shareholders can make a complaint to the Central Government requesting for conducting the special audit. If the Central Government is satisfied that there exist sufficient reasons, it may order a special audit to be carried out by a Chartered Accountant who may or may not be company's statutory auditor or who may or may not be in practice.

DRAFT APPLICATION

Dated_________

To,
The Secretary,
Department of Company Affairs,
Ministry of Company Affairs,
Government of India,
(Address)
New Delhi

Sir,

We, the undersigned, the shareholders of LPM Paper Mills Ltd. would like to bring to your kind notice that for a long time the affairs of the said company are not being managed in accordance with sound business principles and prudent commercial practices.

We are of the view that certain expenditures which are being incurred by the company are not related to the business of the company and the company is not getting any benefit out of such expenses. Moreover, we have the apprehension that there are certain business transactions which are being entered into by the directors with the concerns which are owned by the relatives of the Directors and the prices charged for such transaction are not comparable with the prices charged by other parties for similar transactions. (Students may state any other circumstances also).

If such a state of affairs is allowed to be carried on for long, the financial position of the company will reach a stage where it will endanger its solvency.

We feel that the manner in which such transactions are entered into it may be difficult for the regular statutory auditor to detect them in course of normal audit.

It is, therefore, prayed that the Central Government be pleased to appoint, pursuant to Section 233A of the Companies Act, 1956, a Special

Auditor to properly audit the accounts of the Company and find the real nature of the transactions and determine the losses so far sustained and being sustained by the company on this account.

Yours faithfully,

1.

2.

3.

Shareholder

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**Section 233A and 233B**

**Question 56: Distinguish between 'Special Audit' and 'Cost Audit' in respect of the following:**

**(i). The circumstances under which such auditors can be appointed.**

**(ii). The action that can be taken by the Central Government on receipt of reports from such auditors. [CA Final, Nov. 1996]**

**Ans.** Distinction between special audit and cost audit:

(i) **Circumstances under which such audits can be ordered:** Where the Central Government is of the opinion that :

- (a) the affairs of any company are not being managed in accordance with sound business principles or prudent commercial practices; or
- (b) that the company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or
- (c) that the financial position of any company is such as to endanger its solvency:

It may direct a special audit of the company's accounts for a specified period [Section 233A(l)]. Hence a special audit can be ordered by the Central Government only under certain circumstances as specified in Section 233A(1). But Central Government may order cost audit if it is simply of the opinion that it is necessary to do so in relation to any company required under Section 209(1)(d) to include in the books of account the particulars referred to therein.

(ii) **Central Government's action on receipt of reports:** As special audit is ordered under certain special circumstances specified in Section 233A, the Central

Government is empowered to take such action on the report of the special auditor as it considers necessary in accordance with the provisions of the Companies Act or any other law for the time being in force. But if the Central Government does not take any action on the report within four months from the date of its receipt it shall send to the company either a copy of the relevant extracts from the report with its comments thereon and require the company either to circulate that copy or those extracts to the members or to have such copy or those extracts read before the company at its next general meeting.

In the case of cost audit report, the company shall within 30 days from the date of receipt of the report, furnish the Central Government with full information and explanation on every reservation or qualification contained in such report. The Central Government after consideration of the report and the information and explanation furnished by the company, may seek further explanation from the company if it so needs. As in the case of special audit report, the Central Government may take such action on the cost audit report in accordance with the provisions of the Act or any other law as it may consider necessary. It may also direct the company to circulate to members along with the notice of general meeting to be held for the first time after submission of the relevant cost audit report, the whole or part of the report as if may specify.

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**Section 292A**

**Question 57: The paid-up capital of XYZ Limited has been increased from Rs.4 crores to Rs.6 crores. The Board of Directors of XYZ Limited purpose to constitute an 'Audit Committee'. At present the board consists of 10 directors including a Managing Director. Draft a board resolution taking into account the requirements under the Companies Act relating to the constitution of the Audit Committee and the chairman of the audit Committee. XYZ Limited is not a listed public company. (May, 2002)**

**or**

**Question: A private company having a paid-up capital of Rs. 6 crores has been converted into a public company. The company proposes to constitute an Audit Committee. Draft a board resolution covering the following matters taking into account the provisions of the Companies Act, if any, in this regard:**

**(i) Members of the audit committee**

**(ii) Chairman of the audit committee**

**(iii) Quorum for a meeting of the audit committee**

**(iv) Any two main functions of the committee. (May, 2003)**

**or**

**Question: MNC Ltd., a company, whose paid up capital was Rs. 4.00 Crores, has issued rights shares in the ratio of 1:1. The said company is listed with Mumbai Stock Exchange. Whether the company is required to appoint any Audit Committee and if yes, draft a suitable Board Resolution to appoint an Audit committee covering the aspects as provided in the Companies Act, 1956 and the listing Agreement with the Stock Exchange. In case the company is not required to appoint any Audit Committee, state the provisions of the Companies Act, 1956 in respect of appointment of Audit Committee by a Company. [May 07]**

**Answer:** According to section 292A every public company having paid up capital of not less than Rs.5.00 Crores must have an Audit Committee.

The auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the Audit Committee [Section 292A(5)].

As per section 292A(6) of the said Act, the function of the Audit Committee includes the following:

(a) The Audit Committee should discuss with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors.

(b) The Audit Committee should review half yearly and annual financial statements before submission to the Board.

(c) The Audit Committee should ensure compliance of internal control systems.

The Audit Committee shall have authority to investigate into any matter in relation to the items specified in this section or referred to it by the Board and for this purpose, shall have full access to information contained in the records of the company and external professional advice, if necessary. [Section 292A(7)].

The recommendations of the Audit Committee on any matter relating to financial management including the audit report, shall be binding on the Board and if the Board does not accept the recommendations of the Audit Committee, it shall record the reasons therefore and communicate such reasons to the shareholders. [Section 292A(8) & (9)].

The above provisions of law relating to powers and functions of the Audit Committee relating to financial statements will help in achieving one of the objectives of corporate governance, i.e., accountability and avoidance of poor financial reporting. It also ensures that the companies are managed in clean and transparent manner.

### ***Resolution for appointment of an Audit Committee***

RESOLVED THAT pursuant to the provision of section 292A of the Companies Act 1956 and clause 49 of Listing Agreement with the Mumbai Stock Exchange, an Audit Committee of the Company be and is hereby constituted as under:

1. Shri________, Nomineee of IFCI
2. Shri________, Nomineee of IDBI
3. Shri________,
4. Shri________,
5. Shri________, Managing Director

RESOLVED FURHTER THAT the Audit Committee shall comply with the following:

(1) The Chairman of the Committee, who shall be an independent Director, be elected by the members of the committee from amongst themselves.

(2) The Audit Committee shall have meetings periodically as it may deem fit with at least three meeting in a year, viz., one meeting before finalization of annual accounts and one every six months and the quorum for a meeting of the Audit Committee shall be 1/3rd of the total number of members or two directors (other than the Managing Director), whichever is higher.

(3) The Audit Committee shall invite such of the executives (and particularly the head of the finance function) to be present at the meeting of the Committee whenever required by it.

(4) The finance Director, head of internal audit and the auditors of the company shall attend and participate at the meeting without right to vote.

RESOLVED FURTHER THAT the audit Committee shall have the authority to investigate into any matter that may be prescribed under the said section 292A of the Companies Act, 1956 and the matters as mentioned in the Listing Agreements entered into between the Company and the Mumbai Stock Exchange and all the matters as may be referred to it by the Board from time to time and for this purpose the Audit Committee shall have full access to information contained in the records of the Company and external professional advice, if necessary.

RESOLVED FURTHER THAT the Audit committee shall conduct discussions with the auditors periodically about internal control system, the scope of audit including the observations of the auditors and the Audit Committee shall review the quarterly and annual financial statements and submit the same to the Board with its recommendations, if any.

RESOLVED FURTHER THAT the recommendations made by the Audit Committee on any matter relating to financial management including the audit report shall be binding on the Board and where such recommendations are not accepted by the Board, the reasons for the same shall be recorded in the minutes of the Board meeting or communicated to the shareholders.

RESOLVED FURTHER THAT the Audit Committee have the minutes of its meetings drawn and approved by the Chairman of the Committee and the same be circulated to the members of the Board within thirty days from the date of such meeting.

RESOLVED FURTHER THAT the Company Secretary of the Company shall be the Secretary to the Audit Committee.

RESOLVED FURTHER THAT the Chairman of the Audit Committee shall attend the annual general meeting of the Company to provide any clarifications on matters relating to audit as may be required by the members of the company.

RESOLVED FURTHER THAT the Board's Report/Annual Report to the members of the Company shall include the particulars of the constitution of the Audit Committee.

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**Section 619**

**Question 58: On the basis of the information given below, advise M/s XYZ Ltd. about the provisions applicable for the appointment of Auditors.**

**Date of Incorporation 3.10.2002**

**Date of Receipt of Certificate of Commencement of Business 18.10.2002**

**Nominal value of Equity shares held (Rs. In Lakhs)**

| | |
|---|---|
| **Uttar Pradesh Government** | **11,600** |
| **Central Government** | **8,000** |
| **Bharat Heavy Electricals Ltd. (A Corporation controlled by the Central Government)** | **8,000** |
| **Private Sector Companies** | **8,800** |
| **Indian Mutual Funds** | **4,000** |
| **Foreign Financial Institutions** | **4,000** |
| **Individual Members** | **3,600** |
| **Total** | **48,000** |

**(November, 2002)**

**Answer:** On the basis of the information given in the question the following is the share holding pattern in respect of XYZ Ltd.

| | *Percentage* | *Nominal Value of Share (in Lakh Rs.)* |
|---|---|---|
| Uttar Pradesh Government | 24.1 | 11,600 |
| Central Government | 16.7 | 8,000 |
| Bharat Heavy Electricals (BHEL) | 16.7 | 8,000 |
| | 57.5 | 27,600 |

Section 619 B(c) of the Companies Act, 1956 provides that provisions of Section 619 shall also apply to companies in which not less than fifty one percent of the paid-up share capital is held by the Central Government, one or more State Governments and one or more Government Companies though such companies themselves are not government companies. Thus the auditor

of such companies can be appointed only by the comptroller and Auditor General of India as per Section 619. In the case of XYZ Ltd., 57.5% of the share capital is held by the combination of Central Government, the State Government of Uttar Pradesh and Bharat Heavy Electrical Ltd. (BHEL), a (Government company). Thus the appointment of the auditors of XYZ Ltd. will be regulated by the provisions of Section 619 and accordingly the auditors can be appointed by the Comptroller and Auditor General of India.

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**Section 619**

**Question 59: M/s Rao & Rao, a firm of Chartered Accountants have to be appointed as the auditors of M/s ABC Co. Ltd., a Government Company. Explain the steps to be taken regarding the appointment and payment of remuneration to the auditors. (November, 2001)**

**Answer:** According to Section 619(2) of the Companies Act, 1956, the auditor of a Government company shall be appointed or re-appointed by the Comptroller and Auditor General of India. Therefore, M/s ABC Company Ltd., the Government Company must approach C&AG for appointment of auditor.

Section 224(8) provides that in the case of an auditor appointed under Section 619 by the Comptroller and Auditor General of India, the remuneration shall be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

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**Miscellaneous**

**Question 60: Explain, how the auditor will be appointed in the following cases:**

**(i) A Government Company within the meaning of Section 617 of the Companies Act, 1956.**

**(ii) The Auditor of the company has resigned on 31st December, 2003, while the Financial year of the company ends on 31st March, 2004.**

**(iii) A company, whose shareholders include the following:**

**(a) Bank of Baroda (A Nationalised Bank) holding 12% of the**

**subscribed capital in the company.**

**(b) National Insurance Company Limited (carrying on General Insurance Business) holding 10% of the subscribed capital in the company.**

**(c) Maharashtra State Financial Corporation (A Public Financial Institution) holding 8% of the subscribed capital in the company. (May, 2004)**

**Answer**

(i) According to section 619, the comptroller and auditor general of India appoints the statutory auditor for a government company and remuneration of the auditor is fixed by the company in the general meeting.

**(ii)** If office of the statutory auditor gets vacated for any reason prior to end of term, the resulting vacancy is called as casual vacancy. If such a casual vacancy arises in the office of auditor due to death, insanity, disqualification or insolvency, etc., but not by resignation, section 224(6) empowers the Board of directors to fill the same. Till the vacancy, so caused, is filled, the remaining auditor or auditors, if any, may act.

Where a casual vacancy results on account of resignation, the vacancy can be filled only in the general meeting. The auditor appointed in a casual vacancy shall hold office until conclusion of the next annual general meeting held after their appointment.

**(iii)** section 224A requires the appointment of auditor to be made by special resolution in the case of a company in which not less than 25% of the subscribed share capital is held whether singly or in any combination, by –

(a) a public financial institution or a government company or Central Government or any State Government, or

(b) 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

(c) a nationalised bank or an insurance company carrying on general insurance business.

In view of the above provisions of the Companies Act, 1956, since the combined holding of the nationalised bank, general insurance company and the financial institution covered by the said provisions is 30% which exceeds the limit of 25% of the subscribed capital of the company, the company has to appoint its auditor in the Annual General Meeting by passing a special resolution.

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**Miscellaneous**

**Question 61: Explain how the auditor will be appointed in the following cases:**

**(i). A Government Company within the meaning of Section 617 of the Companies Act, 1956.**

**(ii). The Auditor of the company has resigned on 31st December 2003, while the Financial year of the company ends on 31st March, 2004.**

**(iii). A company, whose shareholders include the following:**

**(a) Bank of Baroda (A Nationalized Bank) holding 12% of the subscribed capital in the company.**

**(b) National Insurance Company Limited (carrying on General Insurance Business) holding 10% of the subscribed capital in the company.**

**(c) Maharashtra State Financial Corporation (A Public Financial Institution) holding 8% of the subscribed capital in the company. [CA Final, May 2004]**

**Answer**:

**(i)** According to section 619, the statutory auditor of a government company shall be appointed by the Comptroller and Auditor General of India and according to section 224, remuneration of the auditor shall be decided by the company in the general meeting.

**(ii)** A vacancy in the office of the auditor arising due to any reason prior to end of term is called as casual vacancy. In relation to auditor, casual vacancy may arise due to resignation or any other reason.

According to section 224(6)(a), the Board of Directors may fill any casual vacancy in the office of an auditor, but proviso thereto states that where such vacancy is caused by the resignation of an auditor, the vacancy shall only be filled by the company in general meeting. Hence, in the case of resignation by the auditor, the company is required to convene and hold a general meeting and appoint the auditor thereat.

**(iii)** The case of appointment of auditor of a company whose 25% or more of the subscribed capital is held by Government, financial institutions, nationalized banks, General Insurance companies is governed by the provisions of section 224A of the Companies Act,1956. According to the provisions of the said section in the case of a company in which not less than twenty-five percent of the subscribed share capital is held, whether singly or in any combination, by-

(a) a public financial institution or a Government company or Central Government or any State Government, or

(b) any financial or other institution established by any Provincial or State Act in which a State Government holds not less than fifty-one percent of the subscribed share capital, or

(c) a nationalized bank or an insurance company carrying on general insurance business, the appointment or re-appointed at each annual general meeting of an auditor or auditors shall be made by a special resolution.

In view of the above provisions of the Companies Act, 1956, since the combined holding of the nationalized bank, general insurance company and the financial institution covered by the said provisions is 30% which exceeds the limit of 25% of the subscribed capital of the company, the company has to appoint its auditor in the Annual General Meeting by passing a special resolution.

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**Miscellaneous**

**Question 62: How will you deal with the following situation in the matter of appointment of auditors ?**

**(i). The shareholding of LIC and UTI increased from 23% to 27% of the subscribed share capital of the company after issue of notice of the annual general meeting.**

**(ii). Ordinary resolution is passed at the annual general meeting of a company when a special resolution is required to be passed for appointment of auditor.**

**(iii). One of the joint auditors appointed by the company in general meeting resigned. [CA Final, Nov. 96, Nov. 03]**

**Answer:**

**Appointment of auditors:**

*(i)* According to Section 224A, if not less than 25% of the subscribed share capital is held by public financial constructions, the appointment or reappointment at each annual general meeting of an auditor or auditors shall be made by a special resolution. Section 224A does not specify the date on which 25% of the subscribed capital must be held by the special instructions to require the appointment of auditor by a special resolution. But according to the Department of Company Affairs, the material date is the date of the annual general meeting at which the special resolution is required to be passed. It is, therefore, necessary for the company to issue a fresh notice of the annual general meeting in this case and pass a special resolution for the appointment of auditor in the manner required under Section 189.

*(ii)* Here the company has passed ordinary resolution at the annual general meeting instead of passing a special resolution. According to Section 224A(3) of the Companies Act, if the company fails to pass a special resolution, it shall be deemed that no auditor had been appointed by the company at its annual general meeting and the Central Government will be empowered to make the appointment under Section 224(3). For this purpose the company has to make an application to the Regional Director, Department of Company Affairs. There is no prescribed form of application but the circumstances in which the company failed to appoint an auditor in its annual general meeting should be detailed.

*(iii)* If one of the joint auditors resigned, the remaining auditor may act until the vacancy is filled. Since the vacancy is caused by resignation, the Board of Directors are not competent to fill up the vacancy. The vacancy shall only be filled by the company in general meeting [proviso to Section 224(6)(a)].

**<u>Miscellaneous</u>**

**Question 63: How will you deal with the appointment of Auditors in the following cases?**

**(i) The first Auditor has not been appointed by the Board of Directors within one month of incorporation of the company. [CA Final, May 1999, Nov. 2004]**

**(ii) One of the two Joint Auditors appointed in the last Annual General Meeting resigned.**

**(iii) One of the partners of a firm of Chartered Accountants appointed as Auditors died. (CA Final, Nov. 1994)**

**Answer:**

(i) According to section 224(5), the first statutory auditor or auditors of a company shall be appointed by the Board of directors within one month of the date of registration (incorporation) of the company. If the Board fails to exercise its duty within the stipulated period, the statutory auditor can be appointed in the general meeting only.

(ii) Where one of the joint auditors appointed in the annual general meeting resigns, the remaining auditor can continue to act as statutory auditor of the company.

(iii) Where there is a change in the constitution of a firm of Chartered Accountants due to the retirement or death of a partner, the remaining partners can carry on the existing audit assignments standing in the firm's name, provided that the firm continues to be in practice and the companies under audit have the knowledge of the retirement or death of a partner. The firm as such is not dissolved and after reconstitution it continues to carry on its profession in the old name. There is no casual vacancy. As such the question of appointment of new auditors does not arise.