

5. Audit of Accounts

Qualification and Disqualification of an auditor (Section 226)

➤ Qualifications

- a. A Charter accountant within the meaning of chartered accountants act, 1949 may be appointed as an auditor.
- b. A firm whereof all the partners participating in India are qualified for appointment may be appointed by its firm name to be the auditor of the company.
- c. A holder of certificate in part B state entitling him to act as an auditor of companies may be appointed as an auditor of the company.

➤ Disqualifications

- 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 of any third person to the company for an amount exceeding Rs. 1000.
 - e. A person holding any security of the company after a period of one year from the date of commencement of the companies Act, 2000. The expression 'security' means any instrument which carries voting rights.
 - f. A person who by virtue of any of the aforesaid provision is disqualified for appointment as an 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.
- Section 226(3) (b) states that whole time officer or employee of the company cannot be an auditor of the company. A chartered accountant's main business is to render professional service for reward like a lawyer or doctor. Where such service is rendered professionally and not as an officer or employee of the company, a chartered accountant is not disqualified under section 226(3) (b) of the companies act, 1956. Thus, an auditor can simultaneously conduct the statutory and tax audit in a company.
- An internal auditor, he is either insider or outsider he can not be appointed as a statutory auditor of the company.
- If an auditor, after his appointment, becomes subject to any of the above disqualification, he shall be *deemed to have vacated* his office. [Section 226(5)]
- An auditor cannot accept the bookkeeping work as it would place him in a vulnerable position in the matter of free expression of his professional opinion.
- A whole time director is an employee of the company while non-executive director is not an employee of the company but according to definition section 'officer' includes 'director' so a director cannot appoint as an auditor of the company. But, there is no restriction on appointment of past director as an auditor.
- If any relative of the auditor or partner's relative of audit firm held more than 20% share or holding rights in the company then they cannot appoint as an auditor of the company.

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

➤ Ceiling limit

- a. Specified number – ‘An auditor can audit a maximum of 10 companies having a paid up share capital of Rs. 25 lakhs or more. Additionally he can audit a maximum of 10 companies having a paid up capital of less than 25 lakhs.’
- b. In the case of firm of auditors, the ceiling is ‘specified number’ for every partner of the firm who is not in full time employment elsewhere.
- c. Where any partner of the firm is also a partner of any other firm of auditors, the ceiling is ‘specified number’ for such person in all the firms *taken together*.
- d. Where a partner in firm is in full time employment, he shall not be counted as partner when computing the ‘specified number’

➤ Audits excluded

- a. Audit of a private company;
 - b. An audit of a guarantee company having no share capital;
 - c. An audit of a foreign company
 - d. Audit of co-operative societies, trusts and corporations that do not fall within the purview of the Companies act. 1956.
 - e. Tax audit under Income Tax Act, 1961.
 - f. Special Audit and investigations
 - g. A branch audit. (it also not included while calculating ‘specified number’).
- Audit of private company is excluded while computing ceiling, but as per ICAI notification, a chartered accountant can accept a maximum of 30 audits including the audits of a private companies.

Mode of Appointments of an auditor

1. First Auditor [Section 224(5)]

- The first auditor shall be appointed by the BOD within 1 month of the date of registration of the company. If company fails to appoint then, the company can appoint first auditor in general meeting by passing ordinary resolution.
- The first auditors are not required to inform the registrant whether they have accepted the appointment or not.
- The company may remove the first auditor by passing an ordinary resolution at a general meeting; no special notice is required for such removal. Any other person may be appointed in his place of whose nomination has been given to the members of the company not less than 14 days before the date of the meeting.
- The only method of appointment of first auditor is as laid down in section 224(5), therefore the auditors of a newly formed company cannot be appointed through the memorandum or article of association.

2. Subsequent Auditor (Section 224)

- **Section 224(1)** – at every AGM, the auditors are appointed or reappointed by the company by passing an *ordinary resolution*.
- After appointing the auditors, the company shall intimate the auditors such appointment within 7 days of the appointment. The auditor shall intimate to the registrar within 30 days about their acceptance or refusal about appointment. This procedure is for appointment or also for reappointment too so on reappointment also auditor has to intimate registrar.

- The company may, after obtaining the previous approval of the central government, remove the auditor before the expiry of their term by passing an ordinary resolution. [224(7)].
- No special notice is required for such removal but procedures prescribed under section 225(2) and (3) shall be followed.

3. Reappointment of retiring auditor [section 224(2)]

- At an AGM, a retiring auditor shall be reappointed except under any of the following situations
 - a. Where he is not qualified for reappointment.
 - b. Where the retiring auditor has, in writing, expressed his unwillingness to be reappointed.
 - c. Where a resolution has been passed at that meeting appointing somebody instead of him or providing expressly that he shall not be reappointed.
 - d. Where notice has been given of an intended resolution to appoint some person in the place of a retiring auditor, and by reason of the death, incapacity or disqualification of that person the resolution cannot be processed with.
- Appointment or reappointment of an auditor is a specific item in the agenda of the general meeting and therefore passing of a resolution for his reappointment is necessary.

4. Appointment of auditor by central government [section 224(3) and (4)]

- Where at an annual general meeting, no auditors are appointed or re-appointed; the company shall, within 7 days give notice of that fact to the central government.
- On receipt on notice from the company, the central government may appoint a person to fill the casual vacancy.
- Circumstances in which no auditor is deemed to be appointed and such appointment by CG.
 - a. Where the appointment of a person appointed as an auditor is void
 - b. Where ordinary resolution is passed, but the appointment of auditor requires special resolution.

5. Casual vacancy in the office of auditors [section 224(6)]

important

- **Causal vacancy**
 - a. It implies vacancy caused by the auditor ceasing to act as such after a valid appointment. i.e., due to death, disqualification, resignation etc.
 - b. A casual vacancy does not arise because of a fault of the company to reappoint an auditor.
 - c. It must be noted that a vacancy caused by the *resignation*, than it only filled by the shareholders in general meeting.
- Any auditor appointed in a casual vacancy, shall hold office until the conclusion of next annual general meeting.

6. Appointment of auditor by special resolution (Section 224A)

- The appointment or reappointment of an auditor shall be made by a special resolution if not *less than 25% of the subscribed share capital*, whether singly or in any combination is held by-
 - a. A public financial institution;
 - b. a government company;
 - c. the central government;
 - d. any state government;
 - e. any financial or other institution established by an provisional or state act in which a state government holds not less than 52% of the subscribed share capital;
 - f. a nationalized bank;
 - g. an insurance company carrying on general insurance business;

- The material date to determine whether section 224A is attracted or not, is the date of annual general meeting.

Remuneration of an auditor [section 224(8)]

- **Right to fix the remuneration**
 - a. Where the appointment is made by the shareholders in general meeting than shareholders determine the remuneration and manner in which the remuneration shall be fixed.
 - b. Where the appointment is made by any other authority than they shall fix the remuneration.
- In government companies auditor is appointed by C&AG, but the remuneration for auditor is fixed by the shareholder in general meeting.
- Remuneration means any sum paid by the company in respect of auditor's expense is treated as remuneration. And if any extra remuneration can be paid to the auditor for other services rendered. But other fees must be separately disclosed in account.

Removal of auditor

Where the auditor in orderly delays or refuses to audit and refuses to resign, the only course open to the company is to have the auditor removed. The auditor may also be held liable for professional and other misconduct.

For removal of auditor in following situation than procedures prescribed under section 225(2) and (3) must be require to follow:

1. Removal of first auditor (before the first AGM)
2. Removal of subsequent auditor before expiry of their term
3. Removal at an AGM

In first case special notice is not required to given. And if auditor is removing by the central government than procedure prescribed under section 408 must be following.

➤ Procedures under section 225(3) and (4)

- a. Notice to the auditor
- b. Rights of the auditor
 - I. Right to be heard orally at the meeting.
 - II. Right to make a representation in writing to the company
 - III. Right to get his representation circulated amongst the members
- c. Duties of the company – in respect of representation given by auditor
 - I. To send a copy of the representation to every member of the company;
 - II. To state the fact of the representation having been made in the notice given to the members.
- d. Position where representation not sent by the company. : if a copy of the representation not send than auditor mat require that the representation shall be read out at the meeting.
- e. Intervention by the company law board:
 - If CLB is satisfied that the right of representation is abused by the auditor to secure needless publicity for defamatory matter than no need to send or read representation at the meeting.
 - The CLB may order to pay the application cost on auditor if he satisfied.
- Where a company has joint auditor and if company want to appoint only one auditor than it's a removal of one auditor so the procedure prescribed above must be follow.

Rights of Auditor (Section 227)

1. right to access books of account
2. right to obtain information and explanation
3. right to attend the general meeting
4. right to heard at the general meeting
5. right to visit at branch office and right to access to books (not for foreign branch)
6. right to receive remuneration
7. right to receive notice of removal
8. right to make a representation on removal
9. right of lien

Duties of Auditor (Section 227 and 229)

1. Duty to make an audit report

- It is the duty of the auditor to make a report to the embers. However, he is not required to send his report to every member.
- In view of the section 230, the auditor's report cannot be taken as 'read', but must be ctually read at the general meeting.

2. Duty to make adequate disclosure in audit report

- Report on true and fair view
- Report on principal assertions
 - a. Whether he has obtained all the information and explanations which to the best of his knowledge and belief for the purpose of audit.
 - b. Whether, proper books of account are maintained by the company.
 - c. Whether, report of branch audit is received by them and how he has dealt with the same in preparing audit report
 - d. Whether profit and loss account and balance sheet comply with the accounting standards
 - e. *In thick type or italics* the observation or comments of the auditors which have any adverse effect on the functioning of the company.
- Report to CARO.
- Report on specific enquiries
- Compliance of accounting standards

3. Duty to give reason for qualifications

- The manner in which qualification are made in the auditor's report should be such as not to leave any doubt in the minds of the public.
- A qualification should be clear in precise.

4. Duty to sign the report

- A person appointed as an auditor of the company
- Where a firm is appointed as an auditor, only a partner in the firm practicing in India.

5. Duty to attend the meetings of audit committee

6. Duty o comply with standards on auditing

Special Audit (Section 233A)

- Circumstances in which special audit may be ordered
 - a. That the affairs of the company are not being managed in accordance with sound business principles or prudent commercial practices.
 - 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.
 - c. That the financial position of the company is such as to endanger its solvency.
- If all the shareholders made a complaint to central government about any above circumstances than after obtaining reasonable enquire and if government satisfy than he can order to do special audit.
- The special audit may be ordered by the central government without providing an opportunity being heard to the company.
- Special audit shall be conducted for such period a may be specified in the order.
- The CG may appoint either the company's auditor or any other chartered accountant (whether or not he is in practice) to conduct the special audit.
- The special auditor has same power and duty like statutory auditor.
- Report of Special Audit
 - a. The report shall also include a statement or any other matter which may be referred to him by the central government.
 - b. the special auditor shall make his report to the central government
 - c. On receipt if the report, CG may takes such action on the report, as it considers necessary.
 - d. if no action is taken within *4 months* from its receipt of report, than CG shall send to the company either a copy of, or relevant extract from, the report with its comments thereon and requires the company either to circulate that copy or those extracts to the members or to have such copy or extracts read before the company as its next general meeting.
- The remuneration of the special auditor and the expenses of special audit shall be determined by the Central Government and such determination shall be final. if the company makes a default in such payment, the same shall be recoverable from the company as an arrear of Ind revenue.

Cost Audit (Section 233B)

- Cost audit – When required
 - a. The company is engaged in production, processing, manufacturing or mining activities
 - b. The company pertains to the class of companies that are required by the central government to maintain the cost records.
 - c. An order is issued by the central government direction the company to conduct cost audit.
 - d. The cost audit is required only for that particular year in respect of which the cost audit order has been issued.
- Cost auditor shall be appointed by the BOD with the previous approval of central government.
- A cost auditor has same power and duties as those of statutory auditor.

Audit committee (section 292A)

- Every public company having paid up capital of Rs. 5 crores or more shall constitute an audit committee.
- The board shall determine the composition of audit committee. In this there are 3 members and two third of the total members shall be director other than managing or whole time director.
- The audit committee shall act in accordance with the terms of reference as specified in writing by the board.

Corporate governance and Audit Committee

- Corporate governance stipulates parameters of accountability, control and reporting function of the Board of directors. It also emphasizes the importance of various stakeholders in direction and performance functions of the company.
- Corporate governance is a process or a set of system and process to ensure that the company is managed to suit the best interests of all the stakeholders.
- Corporate governance calls for total transparency, integrity and accountability of the management, and discharge of social responsibility of the company. The importance of corporate governance lies in its contribution both to business prosperity and to accountability.
- An effective audit committee would assess the risk and judges the audit performance. It would ensure that auditors are a watchdog of interest of stakeholders. It would instill confidence and trust amongst the users of financial statements.
- To conclude, the audit committee is a sincere step to enhance the corporate governance, effective audit function and quality financial reporting. This would restore investor and public confidence, and business and economy will grow as a whole.