Liabilities of Auditors

Question 1

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

(i) A misstatement had occurred in the prospectus issued by the company.

(ii) Certain weaknesses in the internal control procedure in the payment of wages in a large construction company were noticed by the statutory auditor who in turn brought the same to the knowledge of the Managing Director of the company. In the subsequent year huge defalcation came to the notice of the management. The origin of the same was traced to the earlier year. The management wants to sue the auditor for negligence and also plans to file a complaint with the Institute.

(iii) Based upon the legal opinion of a leading advocate, X Ltd. made a provision of ₹ 5 crores towards Income Tax liability. The assessing authority has worked out the liability at ₹ 5 crores. It is observed that the opinion of the advocate was inconsistent with legal position with regard to certain revenue items.

Answer

(i) Under section 35 of the Companies Act, 2013-

(1) Where a person has subscribed for securities of a company acting on any statement included, or the inclusion or omission of any matter, in the prospectus which is misleading and has sustained any loss or damage as a consequence thereof, the company and every person who—

(a) is a director of the company at the time of the issue of the prospectus;
(b) has authorized himself to be named and is named in the prospectus as a director of the company, or has agreed to become such director, either immediately or after an interval of time;
(c) is a promoter of the company;
(d) has authorised the issue of the prospectus; and
(e) is an expert referred to in sub-section (5) of section 26, shall, without prejudice to any punishment to which any person may be liable under section 36, be liable to pay compensation to every person who has sustained such loss or damage.
(2) No person shall be liable under sub-section (1), if he proves—

(a) that, having consented to become a director of the company, he withdrew his consent before the issue of the prospectus, and that it was issued without his authority or consent, or

(b) that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave a reasonable public notice that it was issued without his knowledge or consent.

(3) Notwithstanding anything contained in this section, where it is proved that a prospectus has been issued with intent to defraud the applicants for the securities of a company or any other person or for any fraudulent purpose, every person referred to in subsection (1) shall be personally responsible, without any limitation of liability, for all or any of the losses or damages that may have been incurred by any person who subscribed to the securities on the basis of such prospectus.

Under section 448, an auditor is liable for criminal prosecution, if he, in any return, certificate, balance sheet, prospectus, statement or other document required by or for the purpose of the Act, makes a statement (a) which is false in any material particular knowing it to be false; or (b) which omits any material fact knowing it to be material. If convicted, he can be punished with imprisonment and also with fine as provided under section 447 of the said Act.

(iii) In the given case, certain weaknesses in the internal control procedure in the payment of wages in a large construction company were noticed by the statutory auditor and brought the same to the knowledge of the Managing Director of the company. In the subsequent year, a huge defalcation took place, the ramification of which stretched to the earlier year. The management of the company desires to sue the statutory auditor for negligence. The precise nature of auditor's liability in the case can be ascertained on the basis of the under noted considerations:

(a) Whether the defalcation emanated from the weaknesses noticed by the statutory auditor, the information regarding which was passed on to the management; and

(b) Whether the statutory auditor properly and adequately extended the audit programme of the previous year having regard to the weaknesses noticed.

SA 265 on “Communicating Deficiencies in Internal Control to Those Charged with Governance and Management” clearly mentions that, “The auditor shall determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. If the auditor has identified one or more deficiencies in internal control, the auditor shall determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies. The auditor shall communicate in writing significant deficiencies in internal control identified during the audit to those charged with governance on a timely basis. The auditor shall also communicate to management at an appropriate level of responsibility on a timely basis”. The fact, however, remains that, weaknesses in the design of the internal control system and non-compliance with identified control procedures increase the risk of fraud.
or error. If circumstances indicate the possible existence of fraud or error, the auditor should consider the potential effect of the suspected fraud or error on the financial information. If the auditor believes the suspected fraud or error could have a material effect on the financial information, he should perform such modified or additional procedures as he determines to be appropriate. Thus, normally speaking, as long as the auditor took due care in performing the audit work, he cannot be held liable.

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

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

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

**Question 2**

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

**Answer**

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

The Institute of Chartered Accountants of India has considered the role of chartered
accountants in relation to taxation frauds by an assessee and has made the following major
recommendations:

(i) A professional accountant should keep in mind the provisions of Section 126 of the Evidence
Act whereby a barrister, an attorney, a pleader or a Vakil is barred from disclosing any
communication made to him in the course of and for the purpose of his employment.

(ii) If the fraud relates to past years when the accountant did not represent the client, the
client should be advised to make a disclosure. The accountant should also be careful that
the past fraud does not in any way affect the current tax matters.

(iii) In case of fraud relating to accounts examined and reported upon by the professional
accountant himself, he should advise the client to make a complete disclosure. In case
the client refuses to do so, the accountant should inform him that he is entitled to
dissociate himself from the case and that he would make a report to the authorities that
the accounts prepared or examined by him are unreliable on account of certain
information obtained later. In making such a report, the contents of the information as
such should not be communicated unless the client consents in writing.

(iv) In case of suppression in current accounts, the client should be asked to make a full
disclosure. If he refuses to do so, the accountant should make a complete reservation in
his report and should not associate himself with the return.

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

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

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

Question 3

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

Answer

Duties & Responsibilities of an Auditor in case of Material Misstatement resulting from Management Fraud: Misstatement in the financial statements can arise from fraud or error. The term fraud refers to an ‘Intentional Act’ by one or more individuals among management, those charged with governance. The auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements.

As per SA 240 on “The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements”, fraud can be committed by management overriding controls using such techniques as engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity.

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

Further, an auditor conducting an audit in accordance with SAs is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the SAs.

The risk of the auditor not detecting a material misstatement resulting from management fraud is greater than for employee fraud, because management is frequently in a position to directly or indirectly manipulate accounting records, present fraudulent financial information or override control procedures designed to prevent similar frauds by other employees.

Auditor’s opinion on the financial statements is based on the concept of obtaining reasonable assurance, hence in an audit, the auditor does not guarantee that material misstatements will be detected.

Further, as per section 143(12) of the Companies Act, 2013, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers
or employees of the company, he shall immediately report the matter to the Central Government (in case amount of fraud is ₹1 crore or above) or Audit Committee or Board in other cases (in case the amount of fraud involved is less than ₹1 crore) within such time and in such manner as may be prescribed.

The auditor is also required to report as per Clause (x) of Paragraph 3 of CARO, 2016, Whether any fraud by the company or any fraud on the company by its officers or employees has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit, the auditor shall:

(i) Determine the professional and legal responsibilities applicable in the circumstances, including whether there is a requirement for the auditor to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities;

(ii) Consider whether it is appropriate to withdraw from the engagement, where withdrawal from the engagement is legally permitted; and

(iii) If the auditor withdraws:

(1) Discuss with the appropriate level of management and those charged with governance, the auditor's withdrawal from the engagement and the reasons for the withdrawal; and

(2) Determine whether there is a professional or legal requirement to report to the person or persons who made the audit appointment or, in some cases, to regulatory authorities, the auditor's withdrawal from the engagement and the reasons for the withdrawal.

Question 4

Explain the liability of the auditor under section 35 of the Companies Act, 2013, for making an untrue statement in the report (as an expert forming a part of the prospectus).

Answer

Liability of Auditor under section 35 of the Companies Act, 2013: Under section 35 of the Companies Act, 2013, where a person has subscribed for securities of a company acting on any statement included, or the inclusion or omission of any matter, in the prospectus which is misleading and has sustained any loss or damage as a consequence thereof, the company and every person who—

(a) is a director of the company at the time of the issue of the prospectus;

(b) has authorized himself to be named and is named in the prospectus as a director of the company, or has agreed to become such director, either immediately or after an interval of time;

(c) is a promoter of the company;
(d) has authorised the issue of the prospectus; and
(e) is an expert referred to in sub-section (5) of section 26,

shall, without prejudice to any punishment to which any person may be liable under section 36, be liable to pay compensation to every person who has sustained such loss or damage.

No person shall be liable under sub-section (1) of section 35 if he proves— (i) that, having consented to become a director of the company, he withdrew his consent before the issue of the prospectus, and that it was issued without his authority or consent; or (ii) that the prospectus was issued without his knowledge or consent, and that on becoming aware of its issue, he forthwith gave a reasonable public notice that it was issued without his knowledge or consent.

It may be noted that notwithstanding anything contained in this section, where it is proved that a prospectus has been issued with intent to defraud the applicants for the securities of a company or any other person or for any fraudulent purpose, every person referred to in subsection (1) shall be personally responsible, without any limitation of liability, for all or any of the losses or damages that may have been incurred by any person who subscribed to the securities on the basis of such prospectus.

Question 5

In assessment procedure of M/s Cloud Ltd., Income Tax Officer observed some irregularities. Therefore, he started investigation of Books of Accounts audited and signed by Mr. Old, a practicing Chartered Accountant. While going through books he found that M/s Cloud Ltd. used to maintain two sets of Books of Accounts, one is the official set and other is covering all the transactions. Income Tax Department filed a complaint with the Institute of Chartered Accountants of India saying Mr. Old had negligently performed his duties. Comment.

Answer

Liability of Auditor: “It is the auditor’s responsibility to audit the statement of accounts and prepare tax returns on the basis of books of accounts produced before him. Also if he is satisfied with the books and documents produced to him, he can give his opinion on the basis of those documents only by exercising requisite skill and care and observing the laid down audit procedure.

In the instant case, Income tax Officer observed some irregularities during the assessment proceeding of M/s Cloud Ltd. Therefore, he started investigation of books of accounts audited and signed by Mr. Old, a practicing Chartered Accountant. While going through the books, he found that M/s Cloud Ltd. Used to maintain two sets of Books of Accounts, one is the official set and other is covering all the transactions. Income Tax Department filed a complaint with the ICAI saying Mr. Old had negligently performed his duties.

Mr. Old, the auditor was not under a duty to prepare books of accounts of assessee and he should, of course, neither suggest nor assist in the preparations of false accounts. He is
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responsible for the books produced before him for audit. He completed his audit work with official set of books only.

In this situation, as Mr. Old, performed the auditing with due skill and diligence; and, therefore, no question of negligence arises. It is the duty of the Department to himself investigate the truth and correctness of the accounts of the assessee.

Question 6

Mr. Fresh, a newly qualified chartered accountant, wants to start practice and he requires your advice, among other things, on criminal liabilities of an auditor under the Companies Act, 2013. Kindly guide him.

Answer

Criminal Liability of an Auditor under the Companies Act, 2013: The circumstances in which an auditor can be prosecuted under the Companies Act and the penalties to which he may be subjected are briefly stated below-

(i) Criminal liability for Misstatement in Prospectus- As per Section 34 of the Companies Act, 2013, where a prospectus, issued, circulated or distributed includes any statement which is untrue or misleading in form or context in which it is included or where any inclusion or omission of any matter is likely to mislead, every person who authorises the issue of such prospectus shall be liable under section 447.

This section shall not apply to a person if he proves that such statement or omission was immaterial or that he had reasonable grounds to believe, and did up to the time of issue of the prospectus believe, that the statement was true or the inclusion or omission was necessary.

(ii) Punishment for False Statement - According to Section 448 of the Companies Act, 2013, if in any return, report, certificate, financial statement, prospectus, statement or other document required by, or for, the purposes of any of the provisions of this Act or the rules made thereunder, any person makes a statement-

(1) which is false in any material particulars, knowing it to be false; or

(2) which omits any material fact, knowing it to be material,

he shall be liable under section 447.

Punishment for Fraud - As per Section 447 of the Companies Act, 2013, without prejudice to any liability including repayment of any debt under this Act or any other law for the time being in force, any person who is found to be guilty of fraud, shall be punishable with imprisonment for a term which shall not be less than 6 months but which may extend to 10 years and shall also be liable to fine which shall not be less than the amount involved in the fraud, but which may extend to three times the amount involved in the fraud.
It may be noted that where the fraud in question involves public interest, the term of imprisonment shall not be less than 3 years.

Explanation — For the purposes of this section—

(i) “fraud” in relation to affairs of a company or any body corporate, includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss;

(ii) “wrongful gain” means the gain by unlawful means of property to which the person gaining is not legally entitled;

(iii) “wrongful loss” means the loss by unlawful means of property to which the person losing is legally entitled.

Direction by Tribunal in case auditor acted in a fraudulent manner: As per sub-section (5) of the section 140, the Tribunal either suo motu or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of a company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors.

However, if the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall within fifteen days of receipt of such application, make an order that he shall not function as an auditor and the Central Government may appoint another auditor in his place.

It may be noted that an auditor, whether individual or firm, against whom final order has been passed by the Tribunal under this section shall not be eligible to be appointed as an auditor of any company for a period of five years from the date of passing of the order and the auditor shall also be liable for action under section 447.

It is hereby clarified that the case of a firm, the liability shall be of the firm and that of every partner or partners who acted in a fraudulent manner or abetted or colluded in any fraud by, or in relation to, the company or its director or officers.