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**VIRTUAL COACHING CLASSES  
ORGANISED BY BOS (ACADEMIC), ICAI**

**FINAL LEVEL  
CHAPTER 14 - LIABILITIES OF AUDITOR**

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## 1. NATURE OF AUDITOR'S LIABILITY

A member of the accounting profession, when he is in practice, offers to perform a larger variety of professional services and also holds himself out to the public as an accountant qualified to undertake these assignments. When, therefore, he is appointed under a statute or under an agreement to carry out some professional work it is to be presumed that he shall carry them out completely and with the care and diligence expected of a member of the profession. In view, however, of the fact that the standards of competence may vary from individual to individual and also the concept of the function of an audit and that of its technique, may from time to time undergo change, the auditor is expected to discharge his duties according to “generally accepted auditing standards” obtaining at the time when the professional work is carried out.

The implications of a professional engagement have been explained in the case *Lanphire v. Phipos* (1838) & Case & P. 475 cited in “Professional Negligence” by J.P.Eddy, as follows:



“Every person who enters into a learned profession undertakes to bring to the exercise of it a reasonable degree of care and skill. He does not undertake, if he is an attorney, that at all events he shall gain his case, nor does a surgeon undertake that he will perform a cure; nor does he undertake to use the highest degree of skill. There may be persons who have a higher education and greater advantages than he has; but he undertakes to bring a fair, reasonable and competent degree of skill.”

Either absence of the requisite skill or failure to exercise reasonable skill can give rise to an action for damage for professional negligence.

## **1.1 Taking Assistance in the Discharge of his Duties**

It is a well accepted legal principle that duties under a contract can be assigned only in cases where it does not make any difference to the person to whom the obligation is owed, which of the two persons discharges it. But contracts involving personal skill, or other personal qualifications normally cannot be assigned. It, therefore, follows that the work of an auditor being of a personal character, it must be performed either by him or by his persons under his



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supervision since he himself remains finally responsible. Only to ensure that this scheme shall be adhered to in all cases, clause (12) of Part I of First Schedule to the Chartered Accountants (Amendment) Act, 2006 makes it obligatory that reports on financial statements would be signed either by the member or his partner.

It is quite common for the auditors to engage persons some of whom are professionally qualified, while others are not, to assist them in their work. The principals, however, are expected to guide and supervise their work and are personally responsible for any dereliction of duty or absence of care or skill in performance of an audit or any other professional engagement. They cannot ordinarily shift any part of this liability to their employees.

**Such legal position is clearly borne by the following extracts from the judgements in two renowned cases:**

1. In Henry Squire (Cash Chemists) Ltd. v. Ball Baker & Co.: “The principal must not excuse himself for his clerk’s negligence by saying that he employed a clerk.”
2. In the Superintendent of Police v. M. Rajamany: “No auditor can escape from personal liability by taking shelter under the misconduct of his own employees.”



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The decision in the Rajamany's case also places a limitation on the extent to which an auditor may delegate his duties to his assistants:

“Callousness and irresponsible abdication of his (auditor's) work can never be regarded as anything but misconduct. An auditor who does not personally look into the accounts but merely delegated it to his assistants cannot be said to be acting with due skill and care.”

Despite the fact the principal is responsible for the misdemeanor and misdeeds of his employees, in order that some of them as are qualified may discharge their duties, which are assigned to them with adequate skill and care, the Council has issued the following Council General Guidelines, 2008 No. 1-CA(7)02/2008 dated 8th August 2008 in the exercise of powers vested in it by Chapter II:

“In exercise of the powers conferred by Chapter II of Council General Guidelines, 2008 No. 1-CA(7)02/2008 dated 8th August 2008, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.”



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In the absence of this clause, only the Chartered Accountant who had signed the report would be liable and it would not be possible to reach the employee chartered accountant on grounds of misconduct. The above Council General Guidelines, 2008 No. 1-CA (7)02/2008 dated 8th August 2008 safeguards the interest of members who engage Chartered Accountants and issue reports on the basis of the work carried on by them.

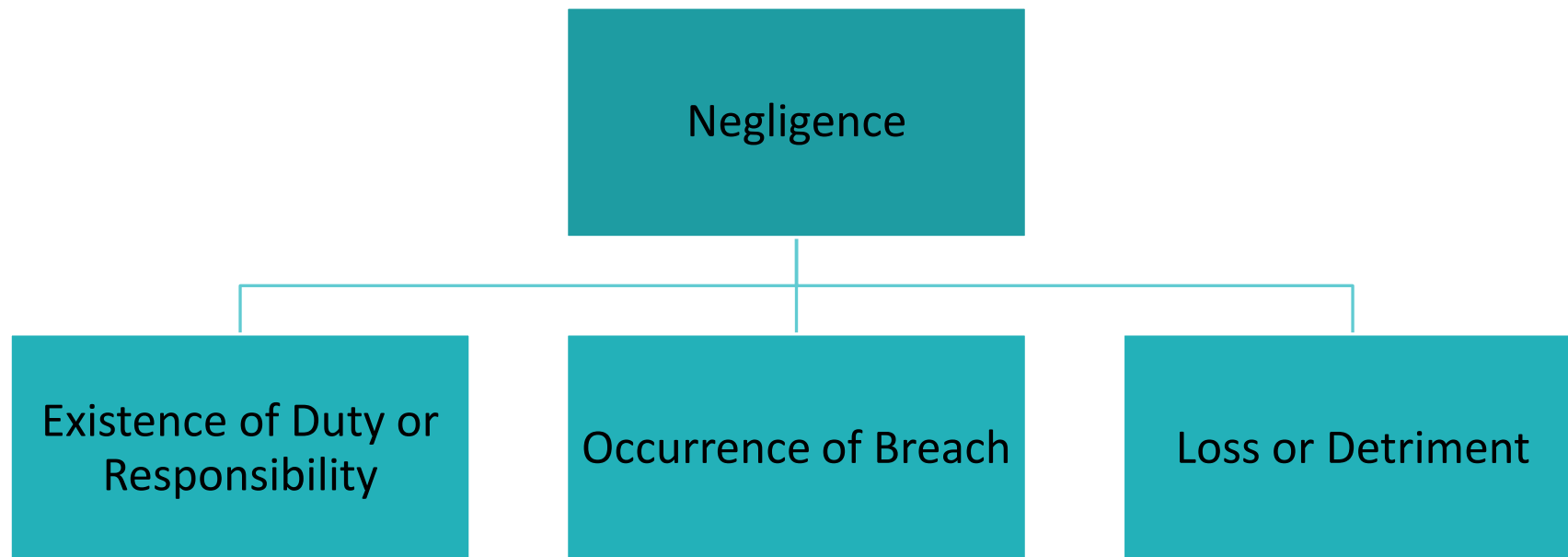
## **1.2 Basis of Liability**

The liability for professional negligence may arise either under a statute or an agreement; the liability may be civil or criminal, disciplinary action for professional misconduct under section 21 of the Chartered Accountants Act can also be taken against a Chartered Accountant for failure to discharge his professional duties competently or diligently.



## 2. PROFESSIONAL NEGLIGENCE

Negligence, which is culpable, generally consists of under mentioned three elements:





- a) existence of duty or responsibility owed by one party to another to perform some act with certain degree of care and competence;
- b) occurrence of a breach of such duty; and
- c) loss or detriment, being suffered by the party to whom the duty was owed as a result of negligence.

In this context, professional negligence would constitute failure to perform duties according to “accepted professional standards”, resulting in some loss or damage to a party to whom the duty is owed.

### **A. To whom is the duty owed?**

A professional man is deemed to have been negligent only when he owed a duty to a person or persons and he had failed to perform or had performed it negligently. If a loss had been suffered by a client through the action of the auditor, his liability would be determined on the basis of the contract of engagement according to which the auditor had undertaken to provide service. When a loss has been suffered by a third party who is not privy to the arrangement between the clients and the auditor for determining whether he is liable, it is necessary to find





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out whether the auditor owed any duty to him. This will be apparent from the summary of legal decisions discussed hereinafter.

The financial statements, on which the auditors report, are designed to serve the needs of a variety of users, particularly owners and creditors. There are users who have direct economic interest in the concerned business enterprise like the owners, creditors and suppliers, potential owners, management, taxation authorities, employees and customers. There are also others who have indirect interests like financial analysts and advisers, stock exchanges, lawyers, regulatory authorities, financial press, trade associations and labour unions. Usually, these parties are not in privity with the auditor. Under what circumstances these parties not in privity should with the auditor be allowed to recover from the auditor losses that they incur as a result of the auditor's dereliction of duty? The solution seems difficult. To hold a negligent auditor liable "in an indeterminate amount for an indeterminate time to an indeterminate class" will be stretching the limit too far. We cannot at the same time brush aside the whole concept of auditors' liability to those parties with whom he has no privity of contract. If responsibility is to be imposed where specific users are identified, then to what extent will it be imposed and what criteria will be used to determine the specific user to whom the auditor should be responsible?



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Liability imposed should have some relation to the responsibility reasonably assumed and the fees charged.

The evolution of law in this regard varies widely in England and the United States. So far as our country is concerned, we should say that much headway has not been made. Hence, it will be highly instructive to analyse the situation under the following three heads:

### 1. English scene:

The general rule in England is that only parties to a contract may enforce the rights under the contract.

**Direct case on an Accountant's liability to third parties:** The question of Accountant's liability to third parties directly came up for consideration in England in the case of **Candler v. Crane Christmas & Co.**



### Case of Candler v. Crane Christmas & Co.

**Findings of the Case:** A firm of accountants had been engaged by a company to prepare the company's accounts. The accountants knew that the statements of account would be shown to third parties. Relying on the statements of account reported upon by the accountants, the plaintiff had invested money in the company and it was lost. The statements in question had been prepared negligently but there was no fraud.

**Judgement / Decision :** Cohen and Asquith L.J.(Denning, L.J. dissenting), held that a false statement made carelessly, as contrasted with one fraudulently made by one person to another, though acted on by that other to his detriment was not action in the able absence of any contractual or fiduciary relationship between the parties Lord Denning, however, dissented, and said:

“the Accountant, who certifies the accounts of his client is always called upon to express his personal opinion whether the accounts exhibit a true and correct view of his client's affairs; and he is required to do this not so much for the satisfaction of his own client but more for the guidance of shareholders, investors, revenue authorities, and others who may have to rely on the accounts in serious matters of business. If we should decide this case in favour of the Accountants there will be no reason why Accountants should ever verify the word of the man in a one man company, because there will be no one to complain about it. The one man who gives them wrong information will not complain if they do not verify it. He wanted their backing for misleading information he gives them and he can only get it if they accept his word without verification. It is just what he wants so as to gain his own ends. And the persons who are misled cannot complain because the accountants owe no duty to them. If such be the law, I think it is to be regretted, for it means that the accountant's certificate which should be a safeguard, becomes a share for those who rely on it. I do not myself think it is the law. In my opinion Accountants owe a duty of care not only to their own clients; but also to those who they know will rely on their accounts in the transactions for which these accounts are prepared.”



**A turning point:** Hedley Byrne & Co. Ltd. v. Heller & Partners Ltd. (1963) All E.R. 575:(1964). I Camp L.J., 14, the House of Lords. In the case, the subject of liability to third parties for negligence of a professional person has been comprehensively reviewed. The House of Lords unanimously overruled the majority decision in Candler v. Crane, Christmas & Co. and upheld Lord Denning's dissenting opinion in that case. Though the Hedley Byrne case did not directly concern an Accountant, the principle laid down in the case is applicable to Accountants.

However, for recent cases have suggested a break away from the Hedley Byrne 'special relationship principle.'

#### **Case of Jeb Fasteners, Marks, Bloom and Co.,**

**Findings of the Case :** Jeb Fasteners - In 1975, Marks, Bloom and Co., the defending firm of auditor reported on the annual financial statements of B.G. fasteners Ltd. for the year ended 31 October, 1974. Stock had been valued at net realisable value of £23,000. instead of at cost of £11,000 resulting in overstated income and balance sheet figure. The auditors were aware of the company's liquidity problems, and had discussions with Jeb Fasteners, the plaintiffs, at the time of takeover negotiations.

Jeb Fasteners subsequently purchased the company, but the takeover was not a success. Consequently, Jeb sued the auditors on the grounds that they were made into purchasing the company by the mis-stated financial statement, and that the auditors had a duty of care to persons whom they could have reasonably foreseen would rely on their audit report.



**Judgement/ Decision :** Justice Woolf ruled that such a duty of care did exist, but the auditors escaped liability on the grounds that the alleged negligence was not the cause of the loss. The judge ruled that the primary purpose of the takeover appeared to be the acquisition of the services of the two B.G. directors, and that a purchase would probably have taken place on the same basis even had the true financial position been known.

Justice Woolf applied a 'reasonable foresight' test, as opposed to the 'special relationship test' of Hedley Byrne. This was based on a judgement by Lord Woolf in the 1977 case of *Anns v. London Borough of Merton*, in which it was held that: 'First, one has to ask whether, as between the alleged wrongdoer and person who has suffered damage there is a sufficient relationship of neighbourhood such that, in the reasonable contemplation of the former, carelessness on his part may be likely to cause damage to the latter, in which case a prima facie duty of care arises.

'Second, if the first question is answered affirmatively, it is necessary to consider whether there are any considerations which ought to negate, or reduce or limit the scope of the duty of the class of person to whom it is owed or the danger to which any breach of it may give rise.'

In *Jeb Fasteners*, Justice Woolf ruled that the auditors were aware of the liquidity problems of B.G. and that financial assistance would become necessary and that a takeover was certainly one method which, was within the contemplation of Mr. Marks (the auditor). Consequently, the judge decided that the events leading to the takeover of B.G. were foreseeable, although it agreed by all parties that at the time of the audit Marks, Bloom and Co. were not aware of reliance by the plaintiffs or even of the fact that a takeover was contemplated.

The Court of Appeal agreed that there was a lack of causal connection between the auditor's negligence and Jeb's loss. It further stated that it was not necessary for it to decide on the extent of liability to confirm in favour of the defendant.

Accordingly, Justice Woolf's ruling has some authority but leaves the extent of third party liability still unconfirmed.



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A usual argument against the extension of liability to third parties is that company law requires the auditor to report to the existing shareholders, for the purposes of stewardship only. And that the accounts have not necessarily been prepared with others in mind. This latter is not a powerful argument, for it is hard to imagine a situation where accounts which are true and fair to members will be sufficiently misleading to others to provide the basis of a claim for negligence. Financial loss to creditors or other third parties will normally only occur as a result of the auditor's default, if the auditors have made some very significant 'goof.' And auditor's, insurers should be well able to cover this risk, which could otherwise unfairly result in individuals bearing the loss.

On the other hand, it can be strongly argued that if the company law wants auditors to report to creditors, and others, it should clearly say so. And tort should not be used as a backdoor approach for creating such a liability; although on grounds of equity one can question whether the auditor should in fact be held responsible for the financial loss of every potential investor and every creditor who seeks to rely on his report. In the words of Cardozo in the famous American case of the *Ultramares Corporation v. Touche*," it would be wrong for accountants to be exposed 'to liability in an indeterminate amount for an indeterminate time to



an indeterminate class'. The amounts involved could indeed be almost infinite, and the fact of reliance very difficult to prove projectively (herein would lie the auditors' the greatest safeguard). Furthermore, it is the directors who should really take primary responsibility for loss through misleading accounts. Yes so often they are 'men of straw' so there is no point in pursuing them; the auditors, with their insurance cover, will prove a much better bet. But should we have to entirely bear this heavy burden, via our insurance premiums, whereas directors can often escape with a suspended jail sentence and their illgotten spoils? Perhaps directors should also carry a mandatory indemnity insurance, as a requirement of holding office.

### **Case of CAPARO Industries V. Touche Ross**

**Findings of the Case :** CAPARO Industries V. Touche Ross -M/s. Touche Ross, a firm of accountants had appealed to the House of Lords from a decision of the Court of Appeal which held that auditors could be sued by an investing shareholder for inaccuracy in accounts or misleading accounts by which a pre-tax profit should have been shown as a loss. On the facts, it was alleged that CAPARO would not have bid for the takeover of Fidelity, a public company, if the true accounts were known.



**Judgement/ Decision :** The House of Lords opined that in advising his clients, the professional owed a duty to exercise the standard of skill and care appropriate to his professional status. He would be liable to contract and tort for losses his client might suffer from breach of the duty. The House of Lords observed that where a statement was put into general circulation and might forcibly be relied on by strangers for anyone of a variety of different purposes which the makers of the statement had no specific reason to anticipate, the duty to use care did not exist. The auditors owed no duty of care to the members of the public who relied on the accounts in deciding to buy shares. It was difficult to visualise a situation in which individual shareholders could claim to have sustained loss in respect of existing shareholdings referable to auditors' negligence which could not be recouped by the company. A purchaser of additional shares stood in the public to whom the auditors owed no duty. It was also held that the purpose of the auditor's certificate was to provide those entitled to the report within information to enable them to exercise their proprietary powers. It was not for individual speculation with a view to profit. The purpose of annual accounts so far as members are concerned, was to enable them to question past management, to exercise voting rights and to influence future policy management.





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In *Al Saudi Bank and others v Clark Pixley and another* (1990), the Caparo principles were applied and, because the auditor had not directly sent a copy of the audited statements to a bank about to grant a loan to his client, and had not been aware that the statements had been distributed, the relationship to the client was not deemed to be sufficiently close. The fact that a potential lender could foreseeably come to possess statements was not enough to create the necessary relationship.

Subsequent to the Caparo case, three more cases have endorsed its doctrine. They are *James Mc Naughton Paper Group Ltd v Hicks Anderson and Co* (1991), where a duty of care was denied again because, it applied to shareholders as a class not as individuals; *Berg Sons and Co and others v Adams and others* (1992), which showed that the auditor's work had been performed only to satisfy the statutory audit requirement and no more, and could not support a duty of care to a finance house that had discounted Berg's bills; and *Goloo and others v Bright Grahame and Murray* (1993) which would not extend the classes of persons to whom the accountant might be liable and which reinforced the view that it must be proved that an auditor's negligence must be the "effective and dominant cause" of loss for a liability to exist.



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Clearly these recent cases have upheld the principles established in the Caparo judgement.

Only one case, Morgan Crucible Co PLC v Hill Samuel and Co Ltd (1991) has threatened to dilute the effects of the Caparo decision. The facts of the case were that company taking over another, relying on information provided by the auditor of the target company, as in Caparo. Since the directors of the target company circularised all their shareholders forecasting a sizeable increase in pre-tax profits, supported by a letter from the auditors and the auditors' opinion was issued after the takeover had commenced, and thus the plaintiff was not relying solely on the accounts but also on these further representations. Thus, it was held the auditor had a duty of care in that, whereas in the Caparo case the audited accounts had been drafted for one purpose but had been relied upon for a different purpose, in this case, the opinion had been relied upon for the purpose for which it was issued. The degree of proximity was such that the defendant could well be liable. The case was settled out of court. Similarly, in Columbia Coffee and Tea Party Ltd v. Churchill and others (1992), the Court held that a third party investor was owed a duty of care on the basis of an assumption of responsibility flowing from statements in the defendant's auditor manual which brought a potential purchaser of shares within the ambit of persons to whom a duty of care was owed. In Possfund v. Diamond (1996), it is being argued that a duty of



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care is assumed and owed to these investors who (as intended) rely on the contents of the prospectus in making subsequent purchases.

## 2. American Scene:

The common law liability of the auditor to third parties is important in any discussion of the auditor's legal liability. A third party may be defined as an individual who is not in privity with the parties to a contract.

From a legal stand-point, there are two classes of third parties:

A **primary beneficiary** is anyone identified to the auditor by name prior to the audit who is to be the primary recipient of the auditor's report.

In contrast, **other beneficiaries** are unnamed third parties.

The auditor is liable to all third parties for gross negligence and fraud under tort law. In contrast, the auditor's liability for ordinary negligence has traditionally been different between the two classes of third parties.



**Liability towards Primary Beneficiaries** - The privity of contract doctrine extends to the primary beneficiary of the auditor's work. The landmark case, *Ultramares Corp. v. Touche* (now *deloitte and Touche*), and its major findings are as follows.

**Case of , Ultramares Corp. v. Touche (now deloitte and Touche)**

**Findings of the Case:** Ultramares upheld the privity of contract doctrine under which third parties cannot sue auditors for ordinary negligence. However, judge Cardozo's decision extended to primary beneficiaries the rights of one in privity of contract. Hence, Ultramares as a primary beneficiary could sue and recover for losses suffered because of the auditor's ordinary negligence.

The defendant auditors, Touch, failed to discover fictitious transactions that overstated assets and stockholders equity by \$700,000 in the audit of Fred Stern & Co. On receiving the audited financial statements, Ultramares loaned Stern large sums of money that Stern was unable to repay because it was actually insolvent. Ultramares sued the CPA firm for negligence and fraud.

**Judgement/ Decision :** The court found the auditors guilty of negligence but ruled that accountants should not be liable to any third party for negligence except to a primary beneficiary.

An analysis of the decision reveals several significant environmental factors that are particularly interesting in view of the current legal environment.



First, the judge recognized that extending liability for ordinary negligence to any third part might discourage individuals from entering the accounting profession, thus depriving society of a valuable service.

Second, he feared the impact that a broader encroachment on the privity doctrine might have on other professionals such as lawyers and doctors.

Third, the decision reaffirmed the auditor's liability to any third party for gross negligence or fraud.

**Liability towards Other Beneficiaries** - The Ultramares decision remained virtually unchallenged for 37 years, and it still is followed today in many jurisdictions. However, since 1968, several court decisions have served to extend the auditor's liability for ordinary negligence beyond the privity of contract doctrine.



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**A Foreseen Class:** The first shift away from Ultramares occurred in the form of judicial acceptance of the specifically foreseen class concept. This concept is explained as follow:

The liability is limited to losses suffered through reliance on the information in a transaction known by the auditor or a similar transaction. In the above instance, this means that the accountant would not be liable if the audit report was used by a bank to invest capital in the client's business in exchange for common stock instead of granting a loan.

The foreseen class concept does not extend to all present and future investors, stockholders, or creditors. Court decisions have not required that the injured party be specifically identified, but the class of persons to which the party belonged had to be limited and known at the time the auditor provided the information.

**Foreseeable Parties:** Individuals or entities whom the auditor either knew or should have known would rely on the audit report in making business and investment decisions are foreseeable parties. This concept extends the auditor's duty of due care to any foreseeable party who suffers a pecuniary loss from relying on the auditor's representation.

Foreseeable parties include all creditors', Stock holders and present and future investors.



**Cases Illustrating Liability to Other Beneficiaries:** The leading cases that extended the accountant's liability for ordinary negligence to foreseen parties and to foreseeable parties are as follows:

### **Case of, Rush Factors Inc. vs. Levin**

**Findings of the Case:** In Rush Factors Inc. vs. Levin (1968), the plaintiff had asked the defendant accountant to audit the financial statements of a corporation seeking a loan. The certified statements indicated that the potential borrower was solvent when, in fact, it was insolvent. Rush Factors sued the auditor for damages resulting from its reliance on negligent and fraudulent misrepresentations in the financial statements. The defendant asked for dismissal on the basis of lack of privity of contract.

**Judgement/ Decision :** The court ruled in favour of the plaintiff. While the decision could have been decided on the basis of the primary benefit rule set forth in ultramares, the court instead said:

The accountant should be liable in negligence for careless financial misrepresentation relied upon by actually foreseen and limited classes of persons. In this case, the defendant knew that his certification was to be used for potential financial of the corporation (emphasis added).



### 3. The Indian Scene:

**Commissioner of Income Tax v. G.M. Dandekar:** This is the only decision on the auditor's liability to a third party by an Indian Court.

#### **Case of, Commissioner of Income Tax v. G.M. Dandekar**

**Findings of the Case:** Mr. Dandekar had been engaged by Messrs A. Mohamad & Co., Madras and had prepared the statements of account and Income-tax Return on the basis of account produced to him. During the course of assessment, it was discovered that Messrs. Mohamad & Co. had maintained two sets of account-regular Day Books and ledgers for the open market transactions and a separate book for the black market transactions. While the former contained detailed entries, relative to daily transactions, the latter contained only consolidated entries, made at the end of the week of the transactions of that week. At the end of the financial year, all the weekly entries in the separate sets of books of account were to called up and were entered in the regular books of account. Mr. Dandekar had examined only the regular books of account of the assessee and prepared the statements of account and the Income-tax Return on the basis of these units. All the statements were signed by him and there was also endorsement at the foot of the Balance Sheet that it had been verified and found to be correct. Mr. Dandekar had forwarded the statements of account to the Income-Tax Officer and, while doing so had stated particulars of books of account that he had examined.





**Judgement/ Decision :** On examination, the statements of account having been found to be wrong, the Income-tax department took up the matter against Mr. Dandekar and filed a complaint with the Institute of Chartered Accountants of India.

When the matter was subsequently considered by the Madras High Court it was held that “he (Mr. Dandekar) was under an obligation to perform auditing with due skill and diligence; if he did that; it would be difficult to see what further obligations he had in the matter and in the favour of whom. The Accountant is under a duty to prepare and resend correct statements of account of the assessee and he should, of course, neither suggest nor assist in the preparations of false accounts. But, he is under no duty to investigate whether the accounts prepared by the assessee are correct or not. The charge is that he owed a duty to the Department to himself investigate the truth and correctness of the accounts of the assessee and not merely to act as their Post Office in transmitting them. We do not agree that the respondent is under any such duty to the Department and, therefore, no question of negligence arises.”



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In view of the English decision (Hedley Byrne's Case) mentioned earlier, the decision in this case may any more be considered to be good law. For, very likely, the Indian Courts may hereafter follow the decision in the Hedley Byrne case and hold that the auditor is responsible to all those persons for negligence who had relied on a financial accounts or statement prepared by him which is incorrect, if he knows or ought to have known that it has been prepared for a particular person or class of persons or may be relied on by the person, or class of persons in that particular connection.

The effect of the Hedley Byrne decision is that someone possessed of a special skill may, quite irrespective of a contract, be considered to have undertaken to apply that skill for the assistance of another person and thereby to have accepted a duty of care to that person. A negligent though honest, misrepresentation which causes financial loss to another may thus, in certain circumstances, give rise to an action for damages at the suit of a person with whom no contract exists.

This doctrine is of particular concern to practising accountants, an important part of whose work consists of preparing, examining or expressing an opinion on financial statements of various



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kinds which may be relied on by persons other than those for whom they were originally intended; the implications should not be overlooked by any accountant who knows that his professional skill, exercised in an independent capacity, whether gratuitously or not, will be relied on by others.

- B. Breach of Duty or Negligence:** To charge a professional man with breach of duty or negligence, it is necessary to prove that there has been a deviation from the standard of care which he was expected to exercise in the performance of his duties. A professional man does not guarantee the success of his professional effort. Nevertheless he is expected to possess a certain amount of knowledge and experience and he must exercise a reasonable degree of care and skill for the performance of duties. If there is any default or failure in the conduct of an audit or in carrying out any other engagement judged by professional standards the person responsible, therefore, would be guilty of negligence.

The auditor being an expert, skilled in the techniques of accounting and auditing, is expected that he would be in possession of certain standards of knowledge and experience. He also must exercise the same degree of prudence, skill and care, as any other professional person, in similar



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circumstances, would be expected to do. In other words, he must carry out the audit according to 'accepted professional standards' (the implications of these words are explained hereafter) and having regard to all facts known to him about the financial solvency of the client.

The auditor, however, is not expected to be a detective nor is he required to approach his work with a suspicious or pre-conceived notion that there is something wrong. He is a watch dog but not a 'blood hound'. However, if there is any thing that excites suspicion in him, he should delve deep into the matter. But, in the absence thereof, he is only required to be reasonably cautious and careful.

In the case of non-company audit, where a detailed audit is not required the scope and extent of routine checking that must be carried out is determined, on a consideration of the nature of engagement. Nevertheless, it is expected that the auditor would carry out the checking of accounts and verification of statements according to 'Standards on Auditing.

Likewise, under the general principles of law, the auditors have been called upon to pay compensation to their clients for the losses suffered by them through their negligence. Only in



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one case, i.e. Armitage v. Brewer and Knott, the auditors were held responsible for the amount of defalcations which arose subsequent to their failure to detect frauds in an earlier period.

### **3. CASES CONCERNING THE CIVIL LIABILITY OF AUDITORS FOR NEGLIGENCE**

In the series of cases considered below, action was brought against the auditors for damages sustained through defalcation of employees or otherwise which, it has been alleged would have been discovered by the auditors, if they had carried out their duties with the required degree of care and skill. The plaintiffs in some cases were individuals or partners and directors in the other companies but action was not brought under misfeasance proceedings of the Companies Act. It may be observed that in general the defence was that the frauds were such that reasonable diligence and careful audit would have failed to reveal them or they were caused by lack of efficiency of the management, or in its supervision over the accounts.

- 1. London Oil Storage Co. v. Seear Hasulk & Co. (1904):** In this case, the auditors were charged with negligence for failure to discover the misappropriation of the petty cash balance, which was shown by the petty cash book at 799 but in fact was only 30. The auditor was found



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guilty of negligence in not verifying the petty cash balance as part of the audit; but the damages awarded were limited to £5.5sh. on the ground that the damages suffered were not due to the conduct of the auditor but that of directors who were guilty of gross negligence in allowing the balance in the hands of the Petty Cashier to increase to such a large amount.

2. **Arthur E. Green & Co. v. The Central Advance and Discount Co. Ltd. (1901):** The auditors in this case had accepted the schedule of bad debts supplied to them by the Managing Director although it was inaccurate and they were far from satisfied with it. Despite the fact, they had failed to qualify their report. The claim filed by the liquidator of the company against the auditors for negligence therefore, succeeded.
3. **Pendleburys Ltd. v. Eills Green & Co. (1936):** The charge in this case was that due to failure on the part of the auditor to verify the amount recorded and received for cash sales, the fraud of the cashier had not been discovered. But the charge did not succeed since the auditors have repeatedly brought the lack of internal check on 'cash receipts to the attention of the three directors who were the only shareholders and debenture holders of the



company. In the course of judgement, the learned judge observed:

“He (the auditor) is there to see that the shareholders get a true representation of the finances of the company as disclosed by its books, this he must do with reasonable care, but in considering whether or not he has displayed reasonable care one must apply rules of common sense. There is all the world of difference between a company which has a large body of shareholders numbering say, six or seven hundred and a company which has only three shareholders; all of whom happen to be the sole directors and the sole debenture holders.....Where the interests of a small company are confined to a very few persons and there are no outside people because all the interests in the company are held by the directors themselves, if the auditor has, in fact, reported to the directors, what more could he be expected to do?”

- 4. Leads Estate and Investment Society Ltd. v. Shepherd (1887):** In this case action was brought by the liquidators against the auditors not under misfeasance proceedings, but under a civil action for the recovery for amounts paid as dividend out of capital. In examining the balance sheet, the auditor had not considered the provision in the Articles and the balance sheet was not properly drawn up. In the course of the judgement, the learned judge observed that it was the duty of the auditor in auditing the accounts of the company not to confine himself to verifying the arithmetical accuracy of the balance sheet,



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but to enquire into its substantial accuracy, and to ascertain that it contained the particulars specified in the Articles of Association, and was properly drawn up so as to contain a true and correct representation of the company's affairs. The auditor was found negligent by the Court.

- 5. Armitage v. Brewer & Knot (1942) ACTC (P 836):** In this case, action was brought by Mr. Joseph Armitage for alleged negligence in auditing the plaintiff's books by reason of which defalcations aggregating to £1440 were not detected. The defalcations consisted in fraudulent alterations of time sheets and petty cash vouchers.

The plaintiff had arranged with the auditor that they would vouch all payments with the receipts entered in the Petty Cash Account, check calculations and additions of wages sheets, check totals of wages sheets into wages book and check weekly totals with other detailed provisions.

Such a detailed audit had been called for since the plaintiff wanted protection against his staff. A special fee was demanded and paid for this work. But it transpired after the audit had been in progress for some two and half years, that the cashier of the plaintiff, by





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altering systematically figures on vouchers of petty cash and making fraudulent entries on time sheets, had misappropriated a large sum of money. During the course of the hearing, it transpired that the auditors had not examined the books of account with sufficient care as a result whereof the fraud committed by the cashier had remained undetected.

Mr. Justice Talbot, during the course of his judgement, observed that “Accountants undertaking duties of that kind could not be heard to excuse themselves on the ground that this or that was small matter.” The auditors were held guilty of negligence and a damage of £1259 was awarded against them.

- 6. Tri-Sure India Ltd. v. A.F. Ferguson & Co.:** Tri-Sure India Limited issued a prospectus of February 75 inviting public to subscribe its share. The prospectus contained, inter alia, the report of the auditors (the defendants) on the accounts of the company for the year 1973-74 which showed that there was an abnormal rise in the rate of profits for the year 1973-74. The public issue was over-subscribed and the company proceeded to allot the shares as per the term of the issue. An investigation later revealed that sales figures for 1973-74 had been manipulated by a whole time director of the company with the active co-operation of other



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top officials of the company. On discovery of this, the company offered to refund all moneys which were subscribed by the allottees and also proceeded to sue the auditors for damages of ` 63.85 lakhs. The company alleged that the auditors failed to examine and ascertain any satisfactory explanation for steep increase in the rate of gross and net profits. The other charges levelled against the auditors were (i) whether the consumption of raw material was commensurate with the sharp increase in sales/production; (ii) the reasons for disproportionate ratio of the total debts due by trade debtors to turnover as compared to the previous years; (iii) the reason for material variation in the ratio of the value of stock on hand to the cost of turnover for the year 1972-73 and for the year 1973-74; (iv) whether there was any change in the prices of prime raw material; (v) whether there was any improvement/deterioration in the usage of material; (vi) whether the company had got new customers and/or there was any change in the terms of credit to customers; and (vii) whether the production for the year was adequate to support the volume of sales and closing stock for the year.

The Court held that the plaintiffs were not able to prove that the auditors were negligent in the performance of their duties. The suit was, therefore, dismissed.



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Regarding the duties of the auditor, the Court held that “the auditor is required to employ reasonable skill and care, but he is not required to begin with suspicion and to proceed in the manner of trying to detect a fraud or a lie, unless some information has reached which excites suspicion or ought to excite suspicion in a professional man of reasonable competence. An auditor’s duty is to see what the state of the company’s affairs actually is, and whether it is reflected truly in the accounts of the company, upon which the balance sheet and the profit and loss account are based, but he is not required to perform the functions of a detective. What is reasonable care and skill must depend upon the circumstances of each case. Where there is nothing to excite suspicion and there is an atmosphere of complete confidence, based on the record of continued success in financial matters, less care and less scrutiny may be considered reasonable.” Thus, the judgment has re-emphasised that an auditor need not proceed with suspicion unless the circumstances are such as to arouse suspicion or ought to arouse suspicion in a professional man of reasonable competence. The practice of resorting to selective verification where internal controls are found to be satisfactory by an auditor has also been upheld in his judgement.



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## 4. CIVIL LIABILITIES UNDER THE COMPANIES ACT

Lord Justice Topes once famously remarked that ***“The Auditor is a watchdog and not bloodhound.”***

A civil action against the auditor may either take the form of claim for damages on account of negligence or that of misfeasance proceeding for breach of trust or duty:

- i. Damages for negligence:** Civil liability for mis-statement in prospectus under section 35 of the Companies Act, 2013, are:
  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—  
shall, without prejudice to any punishment to which any person may be liable under section 36, be liable to pay compensation to every person who has sustained such loss or damage.



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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.
  - c) that, as regards every misleading statement purported to be made by an expert or contained in what purports to be a copy of or an extract from a report or valuation of an expert, it was a correct and fair representation of the statement, or a correct copy of, or a correct and fair extract from, the report or valuation; and he had reasonable ground to believe and did up to the time of the issue of the prospectus believe, that the person making the statement was competent to make it and that the said person had given the consent required by sub-section (5) of section 26 to the issue of the prospectus and had not withdrawn that consent before delivery of a copy of the prospectus for registration or, to the defendant's knowledge, before allotment thereunder.



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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.

It may be noted that the term “expert” as defined in Section 2(38) of the Companies Act, 2013 includes an engineer, a valuer, a chartered accountant, a company secretary, a cost accountant and any other person who has the power or authority to issue a certificate in pursuance of any law for the time being in force. Also that under Section 26 of the Act a statement may be considered to be untrue, not only because it is so but also if it is misleading in the form and context in which it is included.

The liability would arise if the written consent of the auditor to the issue of the prospectus, including the report purporting to have been made by him as an “expert” has been obtained.



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**II. Liability for misfeasance:** The term “misfeasance” implies a breach of trust or duty. The auditor of a company would be guilty of misfeasance if he has been guilty of any breach of trust or negligence in the performance of his duties which has resulted in some loss or damage to the company or its property.

A few cases in which action has been brought against the auditors under misfeasance provisions of the Companies Act are summarised below:

**1. In Re: The London and General Bank, (1895),** held - The auditor who does not report, to the shareholders the facts of the case, when the balance sheet is not properly drawn up, is guilty of misfeasance.

The charge against the auditor in this case was that though he had submitted a detailed report to the directors, as regards loans and overdrafts granted to customers, in respect of which the security lodged was wholly insufficient and had expressed his misgivings as regards recovery of interest on these accounts, included in the Profit and Loss Account, he had neither disclosed the position to the shareholders nor he had made any reference to the report which he had laid before the directors. The words in



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his report, “the value of assets as shown on the Balance Sheet is dependent upon realisation etc.” did not contain any warning to shareholders and the mere presence of these words was not enough to excite suspicion. The Court observed that the duty of the auditor was to convey information and not to arouse enquiry and held that the auditor, by way of damages, was liable to refund the amount of the second dividend (declared in 1892) on the ground that he was aware of the critical position of the affairs and thus had acted negligently in not reporting the facts to the shareholders although he had reported them to directors. As regards the first dividend (declared in 1891), the auditor was not held liable, as he was of the opinion that the evidence was not sufficiently strong to establish a case of misfeasance against him, though he was guilty of an error of judgement.

- 2. In Re: Kingston Cotton Mills Co. Ltd. (1896)**, held - That it is not the duty of the auditor to take stock and that he is not guilty of negligence if the certificate of a responsible official is accepted in the absence of suspicious circumstances.

In this case, the profits of the company had been inflated fictitiously by the deliberate manipulation of the quantities and values of stock-in-trade. The auditors had certified





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the balance sheet on the basis of the certificate of the manager as to the correctness of the stock-in-trade without checking the stock in detail and this fact was shown on the fact of the balance sheet. Lopes L.J. exonerating the auditors of the charge of negligence, in the course of judgement, made remarks to the following effect:

It is the duty of an auditor to bring to bear on the work, he has to perform the skill, care and caution which a reasonably competent, careful and cautious auditor ordinarily would use. What is reasonable skill, care and caution is a matter which must be judged on consideration of the special circumstances of each case. An auditor is not bound to act as a detective, or as had been said to approach his work with suspicion or with a foregone conclusion that there is something wrong. 'He is a watch dog, but not a blood hound'. He is entitled to rely on the representation made to him by the tried servants of the company in whom confidence has been placed by the company, believing them to be honest and truthful. He must, however, take reasonable care to find that the representations made by them are not palpably false. If any matter is observed which is calculated to excite suspicion, he should probe it to the bottom, but in the absence of anything of that kind he is only bound to be reasonable, cautious and careful.



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- 3. The Irish Woolen Co. Limited v. Tyson and others (1900) Act L.R. 23**, held -That an auditor is liable for any damages sustained by a company by reasons of falsification of accounts which might have been discovered by the exercise of reasonable care and skill in the performance of the audit.

In this case, under a special agreement with the company, the auditor was required to conduct a monthly audit, despite the fact, the profit disclosed by the profit & loss account was found to have been inflated by the suppression of certain purchase invoices outstanding at the date of the balance sheet though the goods received in respect thereof had been included in the closing stock. The learned judge hearing the case found that the suppression of invoices would have been detected if the auditor had called for the creditors' statements of account on the basis of which payment had been ordered, in the period subsequent to the audit, and had compared them with ledger balance; also, if the entries in the ledger accounts were checked with relevant invoices, it would have been discovered that these had not been posted on the true dates. On these facts, he concluded that if due care and skill had been exercised, the suppression of the invoices would have been discovered and held the auditor liable for the damages



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which the company had suffered due to understatement of liability in the Balance Sheet.

- 4. In Re: City Equitable Fire Insurance Co. Ltd.,** held -That an auditor is not justified in omitting to make personal inspection of securities that are in the custody of a person or a company with whom it is not proper that they should be left.

In this case, an action had been brought by the Official Receiver as liquidator of the company against the directors and auditors for damages arising out of misfeasance. The chairman of the company was also the senior partner in the firm of Ellis & Co., the company's stock brokers who, at all material times, were heavily indebted to the company.

The principal charge against the auditors was that they had failed to detect and report to the shareholders that a number of company's securities, which were in the custody of Ellis & Co. were being pledged by the firm to its customers. The auditor had relied on the certificate of Ellis & Co. that these securities were held by them. The master of Rolls, on a consideration of the evidence led in this case, showed that it was customary for the auditor to obtain certificate from banks in respect of securities lodged with



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them and that the certificates were not accepted from brokers. He made the following obiter dicta which is of great significance to auditors.

“I think he (the auditor) must take a certificate from a person who is in the habit of dealing with, and holding securities, and who he, on reasonable grounds, rightly believes to the exercise of the best judgement a trustworthy person to give such a certificate.”

- 5. In Re: Westminster Road Construction and Engineering Co. Ltd. (1932),** held- That when there is time lag between the incurring of a liability and receipt of bills and at the time of audit, sufficient time had not elapsed for the invoices relating to such a liability to have been received it was the duty of auditor to make specific enquiries as to the existence of such liabilities. He also must check the valuation of the work in progress at which it is included in the Balance Sheet.

In this case, action had been brought against the auditor by the liquidator of the company in respect of payment of dividend when there were in fact no profits of which it could be paid. Negligence was alleged in respect of over valuation of work in progress, omission of liabilities, etc. The Court held that the auditor was liable to refund to the company the amount of dividend wrongly declared, with interest and costs.



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**6. In Re: S.P. Catterson and Sons Ltd. (1947),** held - That the primary responsibility for the accountant of a company is of those who are in control of the company i.e. the directors.

In the case, an application had been made by the liquidator that the auditor of the company had been negligent in the performance of his duty and thus was liable to compensate the company in respect of amounts misappropriated by an employee of the company, which had become irrecoverable. Though the fact that the defalcation had occurred was accepted, the auditor contended that he had drawn the attention of the directors to the weakness of the system of recording cash and credit sales and had recommended its alteration; notwithstanding this, the system had been continued. Also, that the directors had failed to check adequately the cash records, at the time money was duly handed over, day to day, by the manager.

**7. In Re: Continental Vending Machine Corporation (1970) An American Case** - This is a significant case in as much as it seeks to provide guidelines for the exercise of auditor's judgement and discretion where conclusive accounting and auditing principles are not available to guide the auditor. In this case, the auditor was held guilty of not having reported



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a known fact. The President of the Continental Vending Machine Corporation caused the diversion of a substantial sum of money of the Corporation to his benefit by canalising it through an associated concern the audit of which was conducted by another. A substantial part of the security for this accommodation consisted of securities of the Continental Vending Co., itself. This was not reported and since the amount advanced by this company became irrecoverable, the auditors were held guilty of gross negligence.

The judgement is significant for what it says about the weight the law will attach to the standards of accounting profession and for what it says about obligations of an auditor over and above those imposed by the standards themselves. The test that the Court applied was not whether the balance sheet was in accordance with generally accepted accounting principles but whether the balance sheet fairly represented the financial position.

The Court held that though in ordinary case disposition of funds advanced by the client to its affiliates need not be disclosed by the auditor, such a disclosure becomes necessary in cases of: (i) looting; (ii) known dishonesty by a high official;

(iii) corporation being operated to a material extent for the private benefit of its President;



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and (iv) dishonest diversion of funds. Thus the Court laid down a special rule for disclosure and emphasised that an auditor's approach should not necessarily be limited to the mere compliance with the accepted standards but should primarily be governed by the objective to establish an honest and fair representation of financial facts.

**Damages must be suffered:** In the various cases considered, it may be observed that when an auditor has been found guilty of professional negligence and a loss has been suffered, the Courts have held that the amount of loss should be made good by the auditor. For instance, in the case of Leeds Estate Building and Investment Co. Ltd. v. Shephered, under a civil action by the liquidator, the auditor was held liable to make good, jointly with directors, the dividend paid out of capital.

Where, however, the loss has been occasioned through negligence of directors, the fault of the auditor in failing to verify the asset has been considered to be only technical and only nominal penalty has been imposed. For instance, in the case of London Oil Storage Co. Ltd. v. Seear Husluck and Co. £ 5. 5s was awarded as damages against the auditor, although the loss was much more, on the ground that professional negligence had not occasioned the loss.



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In the case of Armitage v. Brewer and Knot, the auditors were held responsible even for the amount of defalcations which has taken place subsequent to their failure to detect fraud with regard to petty cash in an earlier period. It is the only case in which the principle of consequential damages has been applied to audit claims, i.e. if an auditor omits to detect a defalcation by an employee and, in the following year, before there is a chance of any further audit, the employee emboldened by the non- detection of the defalcation, embezzles a larger sum, the auditor would be liable both for the original loss which he had failed to detect and the subsequent loss suffered by the employer.

Apart from the liability for professional negligence, in the discharge of duties, an auditor also may be penalised under section 147 of the Companies Act, 2013 for failure to comply with any of the provisions contained in sections 143 and 145. He incurs such a liability as auditor of the company.

**As per Sec. 143 of Companies Act, 2013 if auditor does not report any matter of fraud involving such amounts as may be prescribed he will be liable for punishment.**

[**Note:** Students may refer Chapter 5 for Punishment for Contravention as stated in Section 147]





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## 5. CRIMINAL LIABILITY UNDER THE COMPANIES ACT

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:

***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.

***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 —

- (a) which is false in any material particulars, knowing it to be false; or
- (b) 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 [involving an amount of at least ten lakh rupees or one per cent. of the turnover of the company, whichever is lower] shall be punishable with imprisonment for a term which shall not be less than six months but which may extend to ten 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 three years.

It may also be noted that where the fraud involves an amount less than ten lakh rupees or one per cent. of the turnover of the company, whichever is lower, and does not involve public interest, any person guilty of such fraud shall be punishable with imprisonment for a term which may extend to five years or with fine which may extend to fifty lakh rupees or with both.]

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.



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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.

## **5.1 Cases in which an Auditor has been held to have incurred Criminal Liability**

- 1. Dambell Banking Co. Ltd. (1900)** - The directors and auditors, in the case, were prosecuted under section 221 of the Criminal Code of 1872 which is similar to Section 143 of the Companies Act, 2013, for having joined in the issue of false balance sheets, knowing them to be false in material particulars, and with the intent to deceive and defraud shareholders of the company. From the facts provided, it was clear that the accounts were not only false but materially false; letters from the auditors to the managers showed that they (the auditors) thought that overdrafts were bad although taken in as good. They had told the managers that they held strong views about the overdraft, but did not state those views in their certificates to the shareholders. The jury found all the defendants (including the auditors) guilty, and they were sentenced to various terms of imprisonment.



2. **Farrow's Bank Ltd. (1921)** - In this case, there had been a considerable writing up of assets, obviously to show profits available for dividends. In one case a piece of property that cost £5,500 was written up to £7,80,000. The auditor was in the company's regular employment as its accountant and was convicted on various charges of conspiracy and fraud in connection with the published accounts of the bank, and sentenced to 12 months' imprisonment.
3. **Rex v. Lord Kylsant and Another (1931) - (Known as the Royal Mail Steam Packet Company's Case)**: This was a criminal prosecution in which Lord Kylsant who was Chairman of the Board of Directors of Royal Mail Steam Packet Company was charged on two counts.

(a) of publishing an annual report for 1926, which he knew to be false in a material particulars and that the said report concealed from the shareholders the true position of the company, with intent to deceive the shareholders; and

(b) of publishing an annual report for the year 1927, which he knew to be false in a material particular, with intent to deceive the shareholders. Mr. H.J. Morland the auditor, was charged with aiding and abetting Lord Kylsant to commit these offences. Both the accused were acquitted of respective charges, though Lord Kylsant was found guilty and convicted on a separate charge of publishing false prospectus for the issue of fresh debenture stock.



The facts of the case briefly were that the Profit and Loss Account for the year 1926 showed, 'Balance for the year, including dividends on shares in allied and other companies, adjustment of taxation reserves, less depreciation of fleet £4,30,212. Actually this apparent surplus had been arrived at on including undisclosed credits of £5,50,000 from excess Profit Duty, £2,75,000 from Income tax Reserve and £25,776 from investment Profit. If this was not done there would have been a considerable deficit. In 1927, with practically identical wording, a surplus of £2,24,907 was raised to £4,37,293 by similar credits totaling £2,12,386. It must be added that almost the entire amounts of these credits had no relation to the trading of the respective years 1926 and 1927. The contention of the crown was that such item, in the accounts conveyed "a deliberate false representation to the shareholders that the company was making a trading profit when, in fact, it was making a trading loss." The company, in fact, had been drawing upon its secret or hidden reserves from 1921 to 1927. The adjustment of these special credits enabled the company to pay its debenture interest, and dividends on both the preference and ordinary stocks.

Note: The decision in the case has been principally responsible for the change in the phraseology of the auditor's report from 'true and correct' to 'true and fair' requiring a fuller disclosure of any non-trading income or that not belonging to the year, adjusted in the Profit and Loss Account.



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4. **Official Liquidator Karachi Bank v. The Directors, etc. of Karachi Bank Ltd. (1932)** - The directors of the Bank made a statement in the balance sheet that the profit earned by the bank in 1927 amounted to ` 15,608. The amount of profit had been arrived at on taking credit for a sum of ` 45,214, an amount held in suspense for bad or doubtful items of interest. It was held that the official Liquidator should prosecute the managing directors, manager and the auditors for an offence under section 232 of the Indian Companies Act, 1913 (now section 448) of the Companies Act, 2013.

Wild J.C. said “What the Directors of the bank have done is to show a cash profit for the year by adding in a sum which is due, no doubt, but was never paid and was never likely to be paid. The balance sheet, therefore, contains a false statement and a very material one and I am unable to see how it can be argued that it was not intended to be misled.”





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## 6. CASES CONCERNING THE MISCONDUCT OF AUDITORS UNDER THE CHARTERED ACCOUNTANTS ACT

The code of conduct for an auditor should be taken into consideration and the different circumstances under which disciplinary action can be taken against a member; the decisions in a number of cases can be referred to. It being important, however, for students to understand what constitutes 'gross negligence' in terms of Clauses 5 to 8 of Part I of the Second Schedule to the Chartered Accountants Act, two decisions by Indian Courts which have become legal classics, are considered below:

### Case of Deputy Secretary of the Government of India, Ministry of Finance v. S. N. Dass Gupta:

**Findings of the Case:** In this case, action was brought against Shri S.N. Dass Gupta, a member of the Institute, in respect of alleged negligence in the audit of accounts of Aryan Bank Limited, for the years 1942 to 1944. It was alleged that the bank had resorted to manipulation of accounts on an extensive scale. One of the charges was that in 1944 the bank has shown in its Fixed Deposit Ledger certain large sums as having been received on fixed deposit from certain



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concerns in which the Managing Director was interested but the Cash Book of the bank did not show any corresponding entries on the relevant dates. Another charge was that though the auditor had certain doubts as regard loans advanced against fixed deposits, he had not stated the position clearly. It was also alleged that on a certain date in 1944 the Cash Book showed a cash balance of ` 5,00,000 although the actual balance on the date was a little over ` 1,000. The auditor in defence submitted that he had not verified the cash balance in hand and had mentioned this fact in his Special Report.

**Judgement/ Decision :** The learned judge in this regard observed:

“If an auditor does not do what it is his duty to do, it is no defence for him to say in disciplinary proceedings started under Chartered Accountants Act that he had told the shareholder that he had not done it. The lapse is constituted by his failure to verify a duty without which an audit is meaningless and it is not excused by giving information of the omission to the shareholders. Authorities both legal and professional are unanimous that in a bank audit the cash balance claimed by the management must be verified by the auditor because otherwise the management might remove the greater part of the funds and show them falsely lying cash in



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hand and thereby relieve themselves of the necessity of making up accounts showing the disposition of money. In the matter of cash the auditor is not entitled to rely on the certificate of the manager of accepted integrity, according to the principles laid down in the case Re: City Equitable Fire Insurance Co.”

In the matter of the second charge against the auditor that though he had some doubts and misgivings as regards certain losses which might be suffered by the bank due to certain overdrafts accounts proving to be irrecoverable, he had failed to qualify the report in certain

terms indicating the true position of the debits and, instead, had made some cryptic remarks about them in his special report. The learned judge observed, “Either he knew that some of the debts were bad and some of the so called secured loans were not genuine, but he did not wish to inform the shareholders of that fact but wanted at the same time to provide for his own safety and, therefore, he inserted certain cryptic remarks in his Special Report; or he was careless and neglected to give the shareholders the information which it was his duty to give”.



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It was held that the respondent has committed a grave wrong and in consequence he was suspended from the membership of the institute for two years.

The learned judge in his judgement also made the following observation as regards the duties of auditor and methods they should follow for discharging them satisfactorily:

- a) Ascertaining reporting, not only whether the balance sheet exhibits a true and fair state of affairs of the company, as shown by the books of the company, but also whether the books of the company themselves exhibit a true and fair state of the company's affairs.

If any matter has been kept out of the books, with the result that the auditor did not have access to it, he is not responsible for its non disclosure to the shareholders. In this regard the dictum, pronounced by Rigby L.J. in the case Re: London & General Bank, that the words as shown by the books of the company, contained, in the report which the auditors make on the statements of account relieve them the responsibility as regards disclosure of the affairs of the company kept out of the books can be followed.

- b) Verifying not merely the arithmetical accuracy of the statements of account but also their



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substantial accuracy by confirming that they include all the particulars requiring disclosure by the Articles or the Companies Act and otherwise represents true and fair state of affairs of the company.

- c) Checking the accounts and verifying the financial statements with reasonable care and skill. For the purpose, the auditor may properly rely on the statements of the director-in-charge or the Managing Director but only if he is satisfied that the representations made by him appear to be an honest and truthful. All matters which are capable of direct verification should generally be verified directly. But matters which require investigation rather than checking may be verified on the basis of representation of officers of accepted competence and integrity provided there is nothing unusual in the accounts.
- d) Examining the books of the company and obtaining such information or explanation which he considers necessary but not with suspicious mind or by proceeding in a manner he would adopt for detecting a fraud or a lie subject, however, to the fact that he is not in possession of any information which excites suspicion or ought to excite suspicion of a professional man of reasonable competence.



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- e) Verifying the existence of assets and liabilities.
  - f) Making a report to the shareholders as would give them information and not merely means of information, in order that the shareholders may judge the position of the company for themselves. If the auditor is not satisfied as to the accuracy of entries in the balance sheet or they are such that, if disclosed, they would show the balance sheet in a different way, these facts must be conveyed to the shareholders.

### **Case of Controller of Insurance vs H. C. Das:**

**Findings of the Case:** In this case, action was brought against Messers H.C. Dass & Co. by the Central Government in the matter of audit of accounts of Bhagya Laxmi Insurance Limited. The auditors had audited the accounts of the company from 1936 until 1951 and had issued the certificate required under Regulations 7(c) and 7(d) of Part I of the First Schedule to the Insurance Act, 1938. On the appointment of the administrator subsequently under Section 52A of the Insurance Act, a number of irregularities were discovered. The principal defence of the auditor in respect of the charges was that he had relied on statements of the management in



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regard to matters included in the statements certified by him.

**Judgement / Decision:** During the course of the judgement, the learned judge made the following observation:

“As has been said, an auditor is not only blood hound, but he is not also an insurer. He does not certify the absolute accuracy of the accounts which he audits and approves of, but only says that he has taken all possible care and exercised reasonable skill and having done so has arrived at the conclusions which are recorded in his certificate. But if, as we find to our regret to have been the position here, an auditor does nothing at all in the way of scrutinising the books of the company, but only relies upon statements made to him by the management, as his own case find it impossible to hold that he exercised any skill or care of any kind.

“An auditor who construes his duty to shareholders or policy holders too narrowly and who passes and approves of whatever is stated to him by the management of the company whose accounts he audits does not serve the shareholders with the loyalty or efficiency expected of him and constitutes, instead of a source of security to the shareholders, a positive danger to

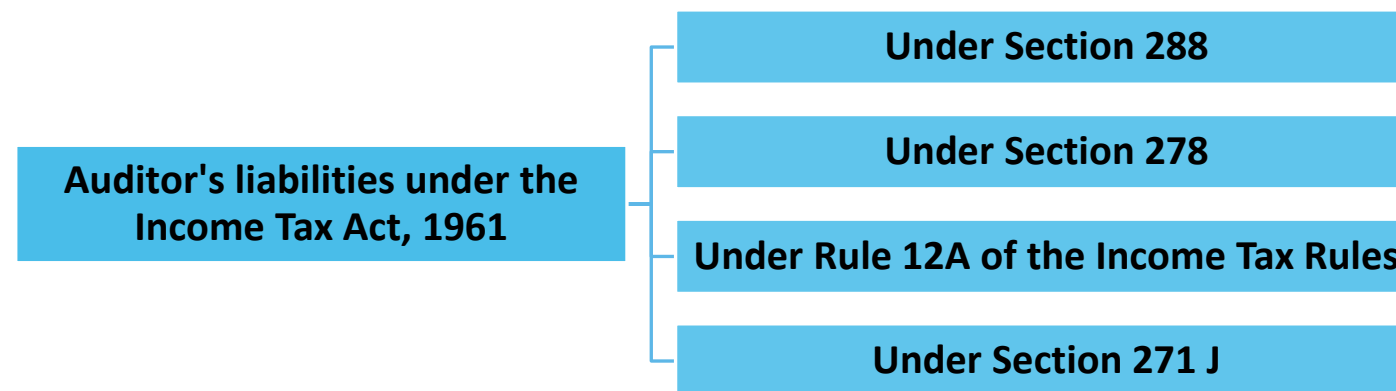


them.”

The auditor was held guilty of gross negligence.

## 7. LIABILITIES UNDER INCOME TAX ACT 1961

In connection with proceedings under the Income Tax Act 1961, a Chartered Accountant often acts as the authorised representative of his clients and attends before an Income Tax Authority or the appellate tribunal. His liabilities under the Income Tax Act of 1961 are as below:







- i. Under Section 288:** A person who has been convicted of any offence connected with any Income Tax proceeding or on whom a penalty has been imposed under the said Act (except under clause (ii) of sub section (1) of Section 271) is disqualified from representing an assessee. The Chief Commissioner/Commissioner of Income Tax has been given powers to determine the period of such disqualification of a person.

### **Section 288 (4) & (5) of the Income Tax Act, 1961**

Sub section 4 of Section 288 of the Income Tax Act:

No person-

- a) who has been dismissed or removed from Government service after the 1st day of April, 1938; or
- b) Who has been convicted of an offence connected with any income tax proceeding or on whom a penalty has been imposed under this Act, other than a penalty imposed on him under [clause(ii) of sub section (1) of section 271 [or clause(d) of sub-section (1) of section 272A]; or
- c) who has become an insolvent; or



d) who has been convicted by a court for an offence involving fraud, shall be qualified to represent an assessee under sub-section (1), for all times in the case of a person referred to in clause (a), for such time as the Principal Chief Commissioner or Chief Commissioner or Principal Commissioner or Commissioner may, by order determine in the case of a person referred to in clause (b), for the period during which the insolvency continues in the case of a person referred to in clause (c), and for a period of ten years from the date of conviction in the case of a person referred to in clause (d).

**Sub section 5 of Section 288 of the Income Tax Act:**

If any person-

- a) who is a legal practitioner or an accountant is found guilty of misconduct in his professional capacity by any authority entitled to institute disciplinary proceedings against him, an order passed by that authority shall have effect in relation to his right to attend before an income-tax authority as it has in relation to his right to practice as a legal practitioner or accountant, as the case may be;
- b) Who is not a legal practitioner or an accountant, is found guilty of misconduct in connection with any income-tax proceedings by the prescribed authority, the prescribed authority (Chief Commissioner or Commissioner having requisite jurisdiction) may direct that he shall thenceforth be disqualified to represent an assessee under sub section (1).



A Chartered Accountant found guilty of professional misconduct in his professional capacity by the Council of the Institute of Chartered Accountants of India, can not act as an authorised representative (for any matter within the definition of a member in practice) for such time that the order of the Council disqualifies him from practising.

- ii. **Under Section 278:** “If a person abets or induces in any manner another person to make and deliver an account or a statement or declaration relating to any income [or any fringe benefits] chargeable to tax which is false and which he either knows to be false or does not believe to be true or to commit an offence under sub-section (1) of section 276C, he shall be punishable,-

**Section 278 of the Income Tax Act, 1961:**

- (i) in a case where the amount of tax, penalty or interest which would have been evaded, if the declaration, account or statement had been accepted as true, or which is willfully attempted to be evaded, exceeds [twenty five] hundred thousand rupees, with rigorous imprisonment for a term which shall not be less than six months but which may extend to seven years and with fine;
- (ii) in any other case, with rigorous imprisonment for a term which shall not be less than three months but which may extend to [two] yeas and with fine



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- iii. Under Rule 12A of the Income Tax Rules:** Under this rule a Chartered Accountant who as an authorised representative has prepared the return filed by the assessee, has to furnish to the Assessing Officer, the particulars of accounts, statements and other documents supplied to him by the assessee for the preparation of the return.

Where the Chartered Accountant has conducted an examination of such records, he has also to submit a report on the scope and results of such examination. The report to be submitted will be a statement within the meaning of Section 277 of the Income Tax Act. Thus if this report contains any information which is false and which the Chartered Accountant either knows or believes to be false or untrue, he would be liable to rigorous imprisonment which may extend to seven years and to a fine.

- iv. Under Section 271J of the Income Tax Act:** As per new section inserted by the Finance Act, 2017 if an accountant or a merchant banker or a registered valuer, furnishes incorrect information in a report or certificate under any provisions of the Act or the rules made thereunder, the Assessing Officer or the Commissioner (Appeals) may direct him to pay a sum of ten thousand rupees for each such report or certificate by way of penalty. [ section 271J]



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**THANK YOU**