

Role of Audit to Protect the Investor's interest under Companies Act, 2013

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Introduction

Audit is a formal examination and verification of financial accounts and records of any organisation. It has become an essential requirement for good corporate governance as it plays a major role in ensuring transparency and accountability in the corporate financial administration, thus auditors are often referred to as gatekeepers. A company carries on business with capital provided by persons who are not in control of the use of the money supplied by them. They would, therefore, like to see their investments are safe, being used for intended purposes and the annual accounts of the company present a true and fair view of the state of affairs of the company. For this purpose, the accounts of the company must be checked and audited by a duly qualified and independent person who is neither employed in the company nor is in any way indebted or otherwise obliged to the company.¹ The contract under which the work of a company's auditor is with the company should be as a separate person. Like anyone who renders professional services for reward, a company's auditor owes the company an implied contractual duty of care in and about the manner in which the audit is performed.² The nature of an auditor's duty of care in the performance of an audit was considered by **Lopes LJ** in *Re Kingston Cotton Mill Co (No-2)*³ which is relevant even today also-

*"It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case. An auditor is not bound to be a detective, or as was said, to approach his work with suspicion or with a foregone conclusion that there is something wrong. He is a watchdog, but not a bloodhound.....an auditor does not guarantee the discovery of all fraud."*⁴

According to **Lord Denning**,

*"An auditor is not bound to be confined to the mechanics of checking vouchers and making arithmetical computations. He is not to be written off as a professional adder-upper and subtractor. His vital task is to take care to see that errors are not made, be they errors of computation, or errors of omission or commission, or downright untruths. To perform this task properly he must come to it with an inquiring mind- not suspicious of dishonesty, I agree- but suspecting that someone may have made a mistake somewhere and that a check must be made to ensure that there has been none"*⁵.

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¹ Majumdar A.K and Kapoor, Company Law and Practice, 15th ed, Taxmann, Page No. 819.

² Equitable Life Assurance Society v. Ernst and Young (2003) EWCA Civ 1114 (2003)

³ (1896) 2 Ch 279 at pp 28-89

⁴ As quoted by Mayson, French and Ryan in their book "Company Law" 26th edition 2009-10, Oxford at p.528

⁵ Fomento (Sterling Area) Ltd v. Selsdon Fountain Pen Co Ltd (1958) 1 WLR 45

Sections 138 to 148 of the Companies Act, 2013 deal with audit and auditors. Internal audit by qualified auditors as decided by the board in the manner prescribed by the Central Government has been made mandatory as per section 138 of the Act. Every company will appoint an individual or firm as an auditor in the Annual General Meeting (AGM) who shall hold office for five years and he shall also be present in every AGM. Section 144 of Companies Act 2013, now, provides for the services which the auditor cannot perform directly or indirectly to the company or its holding company, subsidiary company or associate company. Now there are civil and criminal liabilities, through section 147, have been imposed on auditor and on the partner(s) of an auditor firm who has audited in contravention of provisions of the Companies Act, 2013. In the present article meaning of audit, auditor, qualification of auditors, other essentials for their appointment, their powers and duties, civil and criminal liabilities have been discussed in the light of the Companies Act, 2013 and endeavor has been made to prove that audit is an important means to protect the investor's interests.

I-Meaning of Audit and Auditor

As stated above, Audit is a formal examination and verification of financial accounts and records of any organisation. It is defined as a systematic and independent examination of data, statements, records, operations and performances (financial or otherwise) of an enterprise for a stated purpose. In any auditing the auditor perceives and recognizes the propositions before him for examination, collects evidence, evaluates the same and on this basis formulates his judgment which is communicated through his audit report. The purpose is then to give an opinion on the

Adequacy of controls (financial and otherwise) within an environment they audit, to evaluate and improve the effectiveness of risk management, control, and governance processes⁶. When there is inequality of information between parties, it is desirable, not only between parties concerned, but also from a wider social perspective that the accounts should be attested by an independent third party. A prospective purchaser of a company's share will require this information before he commits himself to investing in the company.

The established convention is to have an independent third party, an auditor, to validate this information⁷. An audit must adhere to generally accepted standards established by governing bodies. These standards assure third parties or external users that they can rely upon the auditor's opinion on the fairness of financial statements, or other subjects on which the auditor expresses an opinion. Audit has revealed many corporate frauds in the past and it is an important means to protect the interests of investors. It plays a major role in ensuring transparency and accountability in the corporate world, thus they are often called as gatekeepers.

Auditing is the central to the public confidence in financial disclosures especially as an auditor is considered to be an intermediary between firms and investors in respect of corporate financial statements. Auditors act as eyes and ears of the shareholders and prospective investors, thus to instill confidence in market and to provide a true and fair account of the company the role of an unbiased objective auditor is an undeniable necessity.

⁶ Audit and Assurance Standard (AAS-1), ICIA.

⁷ Charlesworth's Company Law, 18th edn.(London Sweet and Maxwell, 2011) at page No. 481

II-Objective and Scope of Audit

Originally, the audit function was primarily a public function⁸. Dicksee in his text book on auditing⁹ has outlined the objectives of an audit as-

1. The detection of fraud
2. The detection of technical errors
3. The detection of errors of principle

The means for achievement of such an objective was a detailed analysis of transactions. He has mentioned the concept of internal check and pointed out that when a good system of internal check exists, a detailed audit is frequently not necessary in its entirety.

With the passage of time and the growth of enterprises to the size that made significantly improved internal system of control economical, a detailed audit of transactions became impractical and the objectives of the audit function changed significantly. The auditor's report on financial statements became an end product rather than merely an evidence of absence of fraud. The Institute of Chartered Accountants of India has enumerated the following as the objective of auditing the financial statements¹⁰-

1. Objective of auditing the financial statements prepared within a framework of recognized accounting policies and practices and relevant statutory requirement, if any, is to enable an auditor to express an opinion on such financial statements.
2. The auditor's opinion helps in determination of the true and fair view of the financial position and operating results of an enterprise. The user however should not assume that the auditor's opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.

Therefore, the main objective of auditing today is the evaluation of financial statement to see whether they truly and fairly represent the actual financial status of the organization. Detection of frauds and errors is only an incidental objective. Auditor is often in a position to discover frauds. If after the auditor has completed his audit, a fraud is discovered pertaining in that period, it does not necessarily mean that the auditor has been negligent or that he has not performed his duties completely. The auditor does not guarantee that once he has signed the report on the accounts, no fraud exists. If he has conducted his audit by applying due care and skill in consonance with the professional standards expected, the auditor would not be held responsible for not having discovered that fraud¹¹.

III-Eligibility, Qualifications and disqualifications of Auditor

In India, an auditor is a chartered accountant¹² under the Chartered Accountants Act, 1949 who is appointed to examine the books of account and the accounts of a company registered under the Companies Act, and to report upon them to the company's shareholders. A firm may be appointed in its name provided majority of partners practicing in India are qualified for.

⁸ Majumdar A.K and Kapoor, Company Law and Practice, 15th edn, Taxmann, p. 819.

⁹ I. R Dicksee, Auditing- A Practical manual for Auditors, p.7

¹⁰ see Statement on objective and scope of audit of financial statement, ICAI.

¹¹ Majumdar A.K and Kapoor, Company Law and Practice, 15th edn, Taxmann, p. 821

¹² see. 141 of the Companies Act, 2013

appointment as auditor¹³. Where a firm including a limited liability partnership is appointed as an auditor of a company, only the partners who are chartered accountants are authorised to act and sign on behalf of the firm¹⁴.

An auditor is an officer of the company for the purpose of a misfeasance summons under s.212 of the U.K's Insolvency Act 1986 and for the purposes of offences under ss.206-211 and s.218 of that Act in United Kingdom¹⁵. Where an Auditor is retained to conduct and carry out the audit function without appointment as an Auditor, he may not be treated as officer of the company¹⁶.

The following persons are **not eligible** for appointment as an auditor of a company¹⁷, namely:—

- (a) a body corporate other than a limited liability partnership registered under the Limited Liability Partnership Act, 2008;
- (b) an officer or employee of the company;
- (c) a person who is a partner, or who is in the employment, of an officer or employee of the company;
- (d) a person who, or his relative or partner
 - (i) is holding any security of or interest in the company or its subsidiary, or of its holding or associate company or a subsidiary of such holding company: or
 - (ii) is indebted to the company, or its subsidiary, or
 - (iii) has given a guarantee or provided any security in connection with the indebtedness of any third person to the company, or its subsidiary, or
- (e) a person or a firm who, whether directly or indirectly, has business relationship with the company, or its subsidiary, or its holding or associate company
- (f) a person whose relative is a director or is in the employment of the company as a director or key managerial personnel;
- (g) a person who is in full time employment elsewhere or a person or a partner of a firm holding appointment as its auditor, if such persons or partner is at the date of such appointment or reappointment holding appointment as auditor of more than twenty companies;
- (h) a person who has been convicted by a court of an offence involving fraud and a period of ten years has not elapsed from the date of such conviction;
- (i) any person whose subsidiary or associate company or any other form of entity, is engaged as on the date of appointment in consulting and specialized services as provided in section 144.

IV-Power, Duties and Liabilities of Auditor

It is an established rule that the auditors are to play a vigilant and objective role in ensuring that the investor's interests are well protected and that the management of the company has acted within reason. It is the investors who primarily depend on the good faith and efficiency of the company's auditor

¹³ *Ibid*, proviso

¹⁴ s.141(2)

¹⁵ Charlesworth's Company Law, 18th edn.(London Sweet and Maxwell, 2011) at page No. 487 and in *Re London and General Bank (1895) 2 Ch. 166 CA*.

¹⁶ see Dutta C.R. on the Company Law, 6th edn. (Lexis Nexis, Wadhawa and Co. Nagpur, 2008) at page No. 3733

¹⁷ s. 141(3)

to ensure that company's actions in the day-to-day operations are verified¹⁸. Companies Act, 2013 enjoins certain duties upon the auditor and also gives him certain powers to enable him to discharge these duties effectively.¹⁹ These duties and rights cannot be limited or abridged in any way. Thus, a resolution limiting the powers of the auditor or a provision to this effect in the Articles of Association will be void.²⁰ Any regulations which preclude the auditors from availing themselves of all the information to which they are entitled are inconsistent with the Act.²¹ The rights of auditor includes-

1. Right of access to books and accounts, etc.
2. Right to obtain information or explanation
3. Right to visit and inspect branch accounts of the company
4. Right to attend and speak in general meeting
5. Right to view and study the Article of Association, Memorandum of Association, Prospectus, important contracts of the company etc.

Every auditor has right of access to the books and accounts and vouchers of the company. He may require from the officers of the company any information he thinks necessary for the performance of his duty.²² If any of the provisions of Act (i.e. sections 139 to 146) is contravened, the company shall be punishable with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees and every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to one year or with fine which shall not be less than ten thousand rupees but which may extend to one lakh rupees, or with both.²³

The auditor has to submit a report on the accounts of the company, prepared by its directors, to the members of the company. The report should state whether the accounts are kept in accordance with the provisions of the Act and whether they give a true and fair view of the state of affairs of the company according to accounting standards. In order to prepare an auditor's report, investigations must be carried out which are sufficient to enable the auditor to form an opinion on whether the accounting records have been kept by the company and on whether the accounts for the financial year and the director's remuneration report agree with those accounting records.²⁴

The signed and certified audit report of every financial year are required to be submitted to the members of the company and also to be laid before the company in general meeting. This report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made with that effect and to the best of his information and knowledge, the said accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year and such other matters as may be prescribed. The auditor has also duty to state²⁵

¹⁸ Institute of Chartered Accountants v. P.K. Mukherjee (1968) 38 Com. Cases 628

¹⁹ s.143

²⁰ see C.R Dutta, The Company Law, 6th edn. (Lexis Nexis, Wadhawa and Co. Nagpur, 2008) at p.3772

⁴ Newton v. Birmingham Small Arms Co. Ltd. (1906), 2 Ch. 378

²² see Dr. Avtar Singh, Company Law. 15th edn 2007, EBC, p.455

²³ s. 147

²⁴ Mayson, French and Ryan, Company Law, 26th edition 2009-10, Oxford at p.527

²⁵ s.143(3)

- (a) the details of all the information and explanations which to the best of his knowledge and belief were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements;
- (b) the proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;
- (c) whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns;
- (d) whether, in his opinion, the financial statements comply with the accounting standards;
- (e) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;
- (f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;
- (h) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;

V-Auditor's duty in case of detection of fraud

As discussed earlier, Auditor is often in a position to discover frauds. In circumstances, when the auditor discover that a senior employee of a company has been defrauding that company on a grand scale, and is in a position to go on doing so, then it will normally be the duty of the auditor to report what has been discovered to the management of the company at once.²⁶ The Auditing guidelines, 2000 of ICIA also provides that during the course of his work the auditor identifies the possible existence of a fraud, other irregularity or error the following action should be taken. The auditor should endeavor to clarify whether a fraud other irregularities or error has occurred unless fraud by senior management is suspected, the auditor should inform senior management of his suspicions.²⁷ In case of serious fraud or irregularities which is likely to cause to result in material gain or loss for any person or is likely to affect a large number of persons, the auditor may report directly to a third party without the knowledge or consent of the management. In this context, Enron and Satyam Computer scam are worth to be mentioned here which are glaring examples of serious fraud occurred with the help of their auditors and auditing firm.

In Enron debacle of USA, the executives deceived Andersen auditors about the nature and material terms of the deals in question in order to obtain favourable accounting treatment. However, Andersen failed to use due care to investigate whether Enron's counterparties in monetization transactions actually had any money at risk in the transactions; and that Andersen failed in its duty to flag unusual transactions and controversial accounting decisions for Enron's board. Although Andersen was fully aware of the extent to which Enron's reported financial results were the product of accounting manipulation, it did not insist on disclosure of these facts to investors and the SEC. Thus, Andersen gave "substantial assistance" to Enron officers seeking to disseminate misleading financial information. If Andersen had not assisted and enabled Enron's deception, Enron would have been caught years before

²⁶ Ramaiya, Guide to the Companies Act, 16th edn pp.2398-2399

²⁷ *Ibid*

2001. Indeed, if Andersen had done its job, Enron would not have been able to deceive the investing public in the first place.²⁸

In **Satyam Computers Scam 2009**, has occurred with the help of international reputed audit firm PricewaterhouseCoopers (PwC) which is a big blow for corporate governance in India. This audit firm failed to detect any fraud and certified some thousands of crores of cash lying in bank accounts that apparently did not exist at all. This scam estimated worth of Rs.7,200 crore and caused loss of Rs. 14,162 crore (approx.) to its investors was investigated by the SFIO in record three months of time. Satyam Computer Services Ltd was founded in 1987 by B.Ramalinga Raju, offered information technology (IT) services spanning various sectors, and was also listed on the New York Stock Exchange and Euronext. Satyam's network has covered 67 countries across six continents.²⁹

The auditor who does not report to the shareholders the fact of the case, when the balance sheet is not properly drawn up, is guilty of Misfeasance.³⁰ If an auditor of a company contravenes any of the provisions of section 139, section 143, section 144 or section 145, of the Companies Act, 2013, he will be punished with fine which shall not be less than twenty-five thousand rupees but which may extend to five lakh rupees. If an auditor has contravened such provisions knowingly or willfully with the intention to deceive the company or its shareholders or creditors or tax authorities, he shall be punished with imprisonment for a term which may extend to one year and with fine which shall not be less than one lakh rupees but which may extend to twenty-five lakh rupees. Further if an auditor has been convicted, he will be liable to

- refund the remuneration received by him to the company; and
- pay for damages to the company, statutory bodies or authorities or to any other persons for loss arising out of incorrect or misleading statements of particulars made in his audit report.³¹

Further, Clause (6) Part I, Second Schedule of the Chartered Accountants Act, 1949, provides that, failure of an auditor to report a known material mis-statement in the financial statements of a company, with which he is concerned in a professional capacity, shall be deemed to be '**professional misconduct**'.

VI-Conclusion

The audit is intended for the protection of the investors and the auditing is expected to examine the accounts maintained by the directors with a view to inform investors of the true financial position of the company. The investors of the company have mainly depend upon the good faith and efficiency of the auditor appointed to check the accounts and certify the balance sheet of the company, the auditors do have a chance to make a detailed check of the accounts, call for the information and satisfy themselves that the accounts have been properly maintained and the balance sheet fairly drawn up. The auditors are, therefore, under duty to safeguard the rights of investors *vis-a-vis* the activities of the directors in the purported exercise of their powers in dealing with assets of the company.

It is very important for auditor to use skills and make a reasonable examination of the accounts to see that the dealings are not in any illegal or improper and it is their duty to uncover such activities. As audit has revealed many corporate

²⁸ Astha Suman, Criminal Liabilities of Auditor, retrieved from SSRN

²⁹ Tabrez Ahmad, Satyam Scam in the Contemporary Corporate World, retrieved from SSRN

³⁰ Re London and General Bank (1895) 2 Ch. 166 CA

³¹ s.147

frauds in the past so it is an important means to protect the interests of investors. Auditors play a major role in ensuring transparency and accountability in the corporate world, thus they are often called as gatekeepers, eye and ear of the company. It is also equally true that a fraud may be discovered pertaining to a particular period after the auditor has completed his audit, it does not necessarily mean that the auditor has been negligent or that he has not performed his duties completely. He checks and verifies the books and accounts and vouchers of the company as presented before him. If he has conducted his audit by applying due care and skill in consonance with the professional standards expected, the auditor would not be held responsible for not having discovered that fraud. Therefore it is expected that the auditor should be vigilant in conducting audit of the company.