

# Liabilities of an Auditor

The liabilities of an auditor may be studied from the practical point of view in two ways:

I. When he is appointed by a private concern (a proprietary concern or partnership firm);  
and

II. When he is appointed by a company under the Companies Act, 2013.

## The Liability of an Auditor in a Private Concern

There are no statutes to define the terms of appointment of an auditor, his duties and rights, liabilities, etc., in a private concern. They all depend on the terms and conditions stated in the agreement entered into between him and the client. He must obtain definite and clear instructions from his client as regards the scope of his duties so that he may not be held liable for the work for which he is not so appointed.

If the auditor performs his duties according to the instructions and directions given to him, he is free from any liability.

He certifies the Accounts as correct and reports accordingly. Naturally, the money-lenders of the business believe the accounts as certified by him to be true and correct. If there is any mistake or irregularity left in the financial records, they hold the auditor liable.

The auditor is not liable unless a clear charge of negligence against him is proved in the Court of Law and the business subsequently suffers a loss. This does not mean that he should not perform his duties skillfully and carefully. He must exercise reasonable care, skill and prudence in all circumstances without exception. He does have a moral responsibility towards outsiders and hence he should be honest in his dealings. He must, therefore, not sign the Balance Sheet which he does not believe to be true. Thus, if the auditor adheres to the instructions of his client word by word, he cannot be held liable. He is liable if it is proved that he has done his work negligently and has not obeyed the instructions given to him and, consequently, the business has been put to a loss.

## The Liability of a Company Auditor

A company auditor is appointed under the companies Act, and hence, his position differs from that of one appointed by a private concern.

His appointment, remuneration, rights and duties, liabilities and responsibilities, etc., are defined and laid down by the Companies Act.

His liabilities may be kept under the following heads:

### Liabilities of a Company Auditor

#### Civil Liability

*Liability for Negligence*

*Liability for Misfeasance*

#### Criminal Liability



## Liability for Negligence

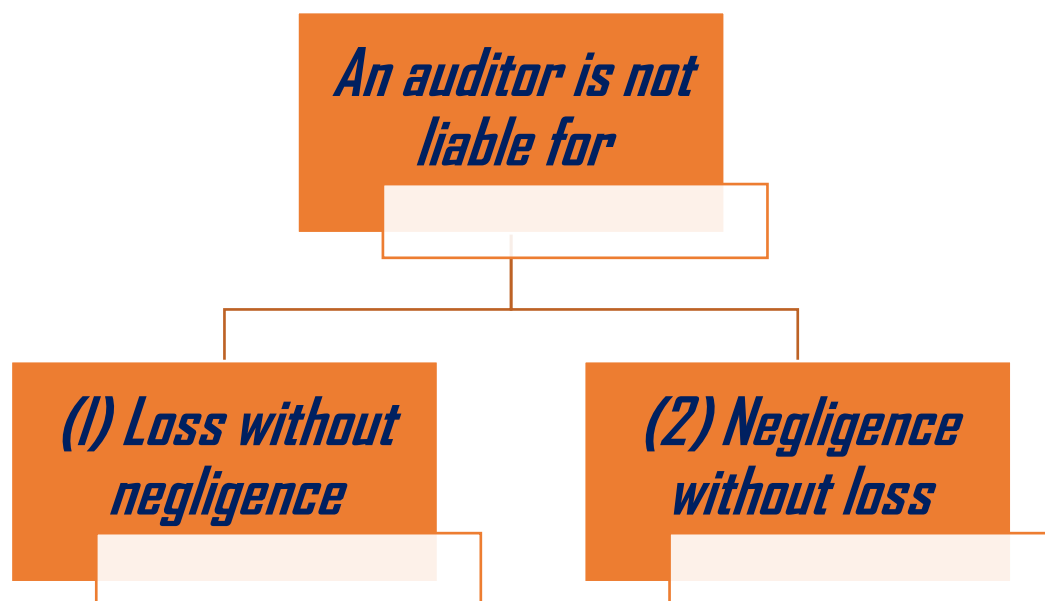
An auditor appointed by a company is expected to safeguard the interests of the shareholders and, as such, he performs his duties as an agent of the shareholders. He must exercise his reasonable care and diligence in the performance of his duties as laid down under the statute. If he fails to do so and as a consequence thereof, the principal suffers a loss, the auditor is held liable to make good the loss under the Law of Agency. Thus, he can be compelled to compensate loss caused to the company resulting from his negligence.

But it has to be remembered that the auditor cannot be held responsible to compensate the loss if his negligence is proved without, in any way, causing loss to the company. He is liable for damages if the company has suffered any loss due to his negligence in the performance of his duties as was held in the case of Liverpool & Wigan Supply Association Ltd. (1907). The situation can be briefly put as given hereunder:

### **An auditor is not liable for**

*(1) Loss without negligence*

*(2) Negligence without loss*



## **Liability for Misfeasance**

As an auditor is held for damages caused to a company on account of his negligence, similarly, he is negligent in the performance of his duties if he commits a misfeasance, i.e., a breach of trust or duty. Misfeasance implies a wrong done. If an auditor does something wrongfully in the performance of his duties resulting in a financial loss to the company, he is guilty of misfeasance. The Directors, Managing Agents and other officials of a company may also be held liable for misfeasance.

## **Legal Position**

Section 62—Where the consent of a person is required to the issue of a prospectus and he has given such consent, he shall not be liable as a person who has authorized the issue of the prospectus. However, he remains liable in respect of an untrue statement, if any, purporting to be made by him as an expert. As such the expert remains liable for untrue statements by him and included in the prospectus with his consent as if he had authorized the issue of the prospectus.

This section provides for the civil liability of an auditor for misstatements in the prospectus of the company.

Section 543—If in the course of winding up of a company, it appears that any officer (including the auditor) of the company has misapplied or retained or become liable for any money or property of the company or has been guilty of any negligence or breach of trust in relation to the company, he can be held liable for damages caused to the company.

## **Criminal Liability**

An auditor is an officer of the company and in that capacity, he is liable for his acts of omission/commission which can be construed as an offence under the provisions of the Companies Act, Penalties for such offences may be imprisonment and/or fine.

## **Legal Position**

Section 63—Where a prospectus issued after the commencement of this Act includes any untrue statement, every person who authorized the issue of the prospectus shall be punishable with imprisonment for a term which may extend to two years or with fine which

may extend to five thousand rupees, or with both, unless he proves either that the statement was immaterial or that he had reasonable ground to believe, that the statement was untrue. For the purpose of this section, an auditor may be punished if he authorized the issue of the prospectus.

Section 233—If an Auditor's Report is made, or any document of the company is issued or authenticated otherwise than in conformity with the requirements of section 227 and 229, the auditor concerned, and the person, if any, other than the auditor, who signs the report or signs or authenticates the document, shall, if the default is willful, be punishable with fine which may extend to one thousand rupees.

Section 240—The auditor of a company is required to give assistance to an Inspector appointed by the Central Government to investigate the affairs of the company. (If he does not do so, he is punishable with imprisonment up to six months or with fine up to Rs. 2,000 or with both.

Section 242—When on the basis of the report submitted by an Inspector, the Central Government takes action and prosecutes any person connected with the affairs of the company, the auditor is required to assist the prosecution. If he does not do so, he is guilty of Contempt of Court and punishable.

Section 477—In the course of winding up of a company, the auditor is subject to a private examination of the Court and is required to return to the Court any documents in his possession. If he fails to appear before the Court, he can be arrested.

Section 478—The auditor of a company, on the application of the Official Liquidator, can be publicly examined in the High Court. The notes shall be taken down and be signed by the auditor. Such notes may be used in evidence against him in any civil or criminal proceeding.

Section 539—If an auditor destroys, mutilates, alters, falsifies or secretes, or is privy to the destruction, mutilation, alteration, falsification or secreting of any books, papers or securities or makes, or is privy to the making of any false or fraudulent entry in any register, book of account or document belonging to the company, he shall be punishable with imprisonment for a term which may extend to seven years, and shall also be liable to fine.

Section 545—The Court may direct the Liquidator of a company in winding up to prosecute the auditor if he is found guilty of any criminal offence in relation to the company.

Section 628—If the audit of a company makes a statement in any Return, Report, Certificate, Balance Sheet, Prospectus, etc., which is false in any material particular knowing it to be false or omits any material fact knowing it to be material he shall be punishable with imprisonment for a term which may extend to two years and shall also be liable to fine.

Section 629—If any person (including an auditor) intentionally gives false evidence upon any examination on oath or solemn affirmation authorized under the Act; or in any affidavit, deposition or solemn affirmation, in or about the winding up of any company under the Act or otherwise in or about any matter arising under the Act, he shall be punishable with imprisonment for a term which may extend to seven years, and shall be liable to fine. Under the Indian Penal Code

Section 197 of the Indian Penal Code (IPC) lays down: "whoever issues or signs any certificate required by law to be given or signed or relating to any fact which such certificate is false in any material point, shall be punishable in the same manner as if he gives false evidence."

### **Powers of the Court to grant relief to the Auditor**

Section 633—If it appears to the Court that an auditor is or may be liable in respect of the negligence, default, breach of duty, misfeasance or breach of trust but that he has acted honestly and reasonably, it can relieve him either wholly or partly from his liability on such terms as it may think fit.

Provided that in a criminal proceeding under this sub-section, the Court shall have no power to grant relief from civil liability which may attach to an officer in respect of such negligence, default, breach of duty, misfeasance or breach of trust.

## LIABILITY OF AN AUDITOR TO THIRD PARTIES

So far we were discussing the liability of an auditor to the company, now we shift to another vital question as to how far he is liable to those who are creditors, bankers, lenders, debenture holders and other persons or institutions having dealings with the company but are outsiders. If they suffer any loss by relying on the Balance Sheet or other Statements or Documents signed by him, can he be held liable for damages so caused to any of them?

The answer is obviously, 'No'. An auditor is never appointed by the third party and as such, he has nothing to do with such a party. There is virtually no contract between the auditor and the third party.

"The auditor owes no duty of care to anybody but his client and he cannot be held responsible for any loss suffered by third parties through reliance on accounts which have been audited by him, even though negligence may be proved."—Candler vs. Crane, Christmas & Co. (1951) According to the judgment given in the case of Le Lievre & Dennes Vs. Gould (1893) it becomes clear that the Court cannot hold an expert responsible for negligence unless a fraud is established against him.

*It should first be proved that:*

*The statement signed by him was untrue in fact,*

*The person making it knows that it was untrue or was recklessly and consciously ignorant whether it was true or not;*

*The Statement was made intentionally for the plaintiff to act upon it, and the plaintiff acted in reliance to it and suffered damages.*

*Thus, only in case of fraud proved in the court of law against an auditor, he can be held liable for damages. Whatever the case, he should exercise reasonable skill, care and tact.*

Briefly, it can be stated that an auditor owes no duty towards third parties. He is liable only when he has knowingly committed some fraud and due to this, they are put to some

damages. Under the Hedley Byrne case, it was indicated that actions for professional negligence may arise only if financial loss is suffered by third parties

*However, to make an auditor liable for the loss suffered by any third party by relying on his report and taking action thereafter, some principle normally accepted can be enunciated and they are:*

*1. It is proved that the auditor showed negligence in his duty and as a result, the third party suffered a loss, and*

*2. When the auditor performs his duty knowing that his work would be relied upon by some third party who may suffer financial loss as a result thereof.*

But it has always to be remembered that an auditor must be honest. He must exercise reasonable care, caution and skill. Unless he is fully satisfied, he must not certify as correct the Profit and Loss Account or Balance Sheet or any other statement. What amount of care and skill will be reasonable will depend upon the circumstances of an individual case. It is certain that if the negligence is proved in the Court and the company is put to a loss as an effect thereof, he will be liable for damages.

He 'must be honest and submit his report after proper scrutiny of accounts in a free and frank way. This is all that he can do.

### **Liability of an Honorary Auditor**

So far as the liability of an honorary auditor is concerned, he is equally well responsible for negligence or misfeasance as a salaried auditor. He cannot be relieved of his liability on the ground that the agreement between him and his chief was not supported by consideration and hence it was void. He should not undertake the work of auditor if he wishes to be free from any sort of liability with his taking over the responsibility of audit work and submitting his report, he is as responsible for his acts as a paid auditor. On this issue, there is actually no difference between the two.—Fairdeal Corporation, Bombay vs. K. Copal Krishna Rao (1957)