

# **COMPANY AUDIT**

## **Part II**

### **Audit Ceiling**

The Companies (Amendment) Act, 1974 added two new sub-sections 224 (1B) and 224 (1C) on ceiling on number of audits. The objective of these sections is to prevent concentration of audits in few hands. These sections were further amended in 1988 and finally revised in the year 2000.

According to Section 224 (1B), an individual cannot be the auditor of more than 20 companies at a time.

Further, out of these 20 companies, not more than 10 should be companies having a paid-up share capital of Rs. 25 lakhs or more. In case of a partnership firm of auditors, the ceiling is 20 companies per partner of the firm and if a partner is also a partner in any other firm, the overall ceiling in relation to such a partner will be 20.

**Example** In a firm of Chartered Accountants, say, there are three partners— X, Y and Z. The overall ceiling of the firm will be  $3 \times 20 = 60$  company audit, out of which not more than  $3 \times 10 = 30$  companies may have paid up share capital of Rs. 25 lakhs or more. Again, say X is also a partner of another firm of Chartered Accountants. In that case, in these two firms, total number of company audit he can undertake as a partner of the firms is limited to 20 only subject to the ceiling of 10 large company audits, i.e., companies having a paid-up share capital of Rs. 25 lakhs or more. It is his responsibility to allocate these 20 company audits between these two firms. Section 224 (1B) has been amended by the Companies (Amendment) Act, 1988 to disallow the appointment of person, who are in full time employment elsewhere, as company auditor. Even in case of partnership, such a partner shall be excluded from counting the number of audits per partner. According to the amendments in the Companies Act in 2000, the above provisions are applicable in case of public limited companies only. So, private limited companies are excluded in computing the ceiling of number of audits. However, the Institute of Chartered Accountants of India has issued a notification [No. 1- CA (7)/53/2001] in the Gazette of India dated May 19, 2001 to include private companies also within the ceiling of 30 companies. According to the notification, “a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he holds at any time appointment of more than specified number of audit assignment of the companies including private companies”.

### **STATUS OF THE COMPANY AUDITOR**

The auditor of a company can be considered a servant of the company, an agent of the shareholders as well as an officer of the company. A Servant of the Company

Like any other employee or director of a company, an auditor also renders his services to the company. The employees get remuneration from the company for their services. The auditor is receiving remuneration from the company (not termed as audit fees) for the services rendered by

him for the company. Hence, like employees of the company, the auditor may also be considered as a servant of the company. But if payment to auditor by the company makes him a servant of the company, it will create lot of confusion. Then the doctor who is paid by the patient is to be treated as servant of the client. So, it would not be logical to treat the auditor as servant of the company.

#### *An Agent of the Company*

Except in certain special situations where an auditor is appointed by the Directors or the Central Government, an auditor is normally appointed by the shareholders. Not only that, the auditor checks the accounts on behalf of the shareholders and he has to submit his report to the shareholders. It therefore appears that an auditor is an agent of the shareholders.

Lord Cranworth in the course of his judgment in the case *Spackman vs. Evans* also said: "The auditor may be the agent of the shareholders, so far as it relates to the audit of the accounts. For the purpose of the audit, the auditors will bind the shareholders". However, according to the Law of Agency, "he who does through another does by himself". It means that any act of the agent will be purported to be the act of the principal. But this relationship does not exist between the shareholders and the auditors. Again, under the same law, the knowledge of an agent regarding a matter is also taken as the knowledge of the principal. So far as company auditor is concerned, he is not supposed to intimate the shareholders any information other than the actual results and financial position through financial statements. Therefore, a company auditor cannot be treated as an agent of the shareholders. He can best be described as the representative of the shareholders under certain circumstances.

**An Officer of the Company** An auditor is an officer of the company under Section 2 (30) of the Companies Act for the purpose of the following sections:

- i. Section 477: Powers to summon persons suspected of having property of the company.
  - ii. Section 477: Power to order public examination of promoters, directors, officers, etc.
  - iii. Section 539: Penalty for falsification of books.
  - iv. Section 543: Power of the court to assess damages against delinquent directors, officers etc. in course of winding up procedure.
  - v. Section 545: Prosecution of delinquent officers and members of the company.
  - vi. Section 621: Offences against Act to be cognizable only on complaint by Registrar, Shareholder or Government.
  - vii. Section 625: Payment of compensation in cases of frivolous or vexatious prosecution.
  - viii. Section 633: Power of the court to grant relief in certain cases.
- Except for the above sections, an auditor shall not be considered as an officer under the Companies Act, 1956. In addition to that there are many legal decisions where a company auditor has been termed as an officer of the company. In *London and General Bank* case, it was held by Justice Lindley that it seems impossible to deny that for some purposes and to some extent, an auditor is an officer of the company. It was also held in the famous *Kingston Cotton Mills Co. Ltd.* case that the auditors are officers of the company. But an officer is bound by the service rules of the company and is required to work as per the directions given to him. But independence in the work of an auditor is a well-established principle. He needs to be independent of management in order to make his report reliable to the shareholders and other

interested parties like bankers, creditors, etc. Therefore, the auditor must work according to his own judgment and independent thought even though that may not suit the desire of management. So, to treat the auditor as an officer of the company is contrary to the basic philosophy of audit.

The position of an auditor is, therefore, a bit controversial. Sometimes he may appear to be an agent of the shareholders and sometimes he may be considered an officer of the company. But an auditor is an independent person rendering professional services to the company in return of fees. He can neither be an agent of the shareholders nor be an officer of the company, nor is he a servant of the company.

### ***AUDITOR'S RIGHTS, DUTIES AND LIABILITIES***

The auditor of a company has statutory rights, duties and liabilities under the Companies Act. Rights of a Company Auditor

An auditor of a company is required to report on the truth and fairness of the financial statement of the company. To perform his duties effectively, he requires some rights and powers. In case of sole proprietor or partnership firm, the rights and duties of an auditor are determined by the agreement entered into by him with the sole proprietor of the partnership firm as the case may be. But the Companies Act, 1956, has specifically laid down the rights and duties of a statutory auditor of a joint stock company. These rights and duties are absolute and cannot be curtailed in any way. Any resolution or provision in the Articles in this regard will be null and void. It was held in the case of *Newton vs. Birmingham Small Arms Co. Ltd.* that any resolution precluding the auditor from of any information to which he is entitled to as per Companies Act is inconsistent with the Act.

The Companies Act provides the following rights to the auditor to enable him to discharge his duties properly:

**Right of Access to Books and Vouchers** Section 227 (1) of the Companies Act, 1956 provides that the auditor of a company shall have the right of access, at all times, to the books and vouchers of the company whether kept at the head office or elsewhere. This right of the auditor is the fundamental basis on which the auditor can proceed to examine and inspect the records of the company for the purpose of making his report. **Right to Obtain Information and Explanations** Section 227 (1) also entitles the auditor to require from the officer of the company such information and explanations as the auditor may think necessary for the performance of his duties. Corresponding to the right to ask for information and explanations, Section 221 of the Act also makes it obligatory for the concerned officers of the company to furnish without delay the relevant information to the auditor.

**Right to Visit Branch Offices and Access to Branch Accounts**

Section 228 (2) of the Companies Act gives specific rights to the company auditor where the accounts of any branch office are audited by another person. The company auditor has the right to visit branch office, if he deems it necessary to do so for the performance of his duties and has the right of access to books and accounts along with vouchers maintained by the branch office.

#### Right to Receive Branch Audit Reports

The company auditor has also the right to receive the audit report from the branch auditor for his consideration and deal with it in such a way, as he considers necessary while preparing his audit report on the accounts of the company.

**Right to Receive Notices and to Attend General Meeting** Section 231 of the Companies Act entitles the auditors of a company to attend any general meeting of the company and to be heard on any part of the business, which concerns him as the auditor. He is also entitled to receive all notices and communications relating to any general meeting of the company.

**Right to Make Representation Pursuant to Section 225**, the retiring auditor is entitled to receive a copy of the special notice intending to remove him or proposing to appoint any other person as auditor. The retiring auditor sought to be removed has a right to make his representation in writing and request that the same be circulated amongst the members of the company. In case, the same could not be circulated, the auditor may require that the representation shall be read out at the general meeting.

#### Right to Sign Audit Report

According to Section 229 of the Companies Act, only the person appointed as auditor of the company, or where a firm is so appointed only a partner in the firm practicing in India, may sign the auditor's report.

#### Right to Seek Legal and Technical Advice

The auditor of a company is entitled to take legal and technical advice, which may be required in the performance of conduct of audit or discharge of his duties [London and General Bank Case].

**Right to be Indemnified** For different purposes, an auditor is considered to be an officer of the company. As an officer, he has the right to be indemnified out of assets of the company against any liability incurred by him in defending himself against any civil or criminal proceedings by the company, if he is not held guilty by the law.

#### Right to Receive Remuneration

On completion of his work, an auditor is entitled to receive his remuneration. The rights of the auditor cannot be limited by any resolution of the members passed in the general meeting [Homer vs. Quitler].

**Right of Lien of Company Auditor** The right of 'lien' means right of one person to retain the property of another person who owes money to the former. The right of lien of an auditor of a limited company indicates his right to retain documents and records of the company for his unpaid fees. The Companies Act is silent about the right of lien of auditors on clients' documents and records. Also there are many conflicting legal judgments regarding this issue. The Institute of Chartered Accountants of England and Wales has issued a guideline in this regard. Based on that guideline, the auditor's lien can be discussed under the following heads:

**Lien on Books of Accounts** In the case, *Herbert Alfred Burleigh vs. Ingram Clark Ltd. (1901)*, it was held that while an auditor acts as an accountant preparing books of accounts, he should have lien on such books of accounts for unpaid fees. But if he merely audits the books of accounts, he will not enjoy any right of lien on them. But allowing auditor to enjoy right of lien on books of accounts prepared by him will conflict Section 209 of the Companies Act, which make it mandatory for every company to keep its books of accounts at its registered office or at such other place in India as the directors think fit. So, the auditor's lien would not be upheld on books of accounts, which the company has to keep in its possession as per the provisions of the Companies Act.

#### **Lien on Working Papers**

Audit working papers are those documents and records, which the auditors prepare in connection with his audit work. In fact, this question of ownership in respect to the working papers arose in the case of *Sockockingky vs. Bright Graham & Co. (1938)* in England. The question was whether the auditor had a right to retain the working papers as if it were their own property even after the payment of the audit fees. The court delivered judgment in favour of the auditors on the ground that they were independent contractors and not agents of the client.

#### **Lien on Communication Documents**

An auditor may communicate with third parties either as an agent on behalf of the client or independently in connection with his work. In this case, the communication documents will belong to the client. However, if the auditor makes correspondence with third parties not as an agent, but as a professional discharging his duties, the correspondence with the third parties will be his property.

#### **Lien on Client's Money**

The auditor should not have any lien on client's money, which may be kept with him. This is simply because he does not work on the money. He may be required to keep the money as a trustee only. So, if the auditor appropriates client's money towards his outstanding fees, he will be held liable.

#### **General or Special Lien**

An auditor has only lien on the particular document in respect of which he has rendered his professional service, but he has not yet been paid. He cannot have general lien, i.e., he cannot retain other documents with which he has not been concerned.

**DUTIES OF A COMPANY AUDITOR** The duties of a company auditor can be described by classifying it in the following categories:

#### **Statutory Duties 1. Duty to Report**

According to Section 227 of the Companies Act, 1956, it is the duty of the company auditor to make a report to the members of the company on the accounts examined by him and on balance sheet and profit and loss account laid before the company in its general meeting. 2. Duty to Enquire

Sub-section (1A) of Section 227 of the Companies Act specifies six matters, which are required to be looked into by a company auditor. The statement on Qualifications in the Auditor's Report issued by

the ICAI clarifies that the auditor is not required to report on the matters specified in sub-section (1A), unless he has any special comments to make on any of the items referred to therein. 3. Duty to Follow CARO

Under Section 227 (4A) of the Companies Act, the Central Government has the power to direct by a general or special order that in the case of specified companies, the auditor's report shall include a statement on such matters as may be specified in its order. In accordance with the provision, the Central Government issued revised order in 2003, namely Companies (Auditor's Report) Order. The auditor has the duty to follow the order.

4. Other Duties Under the Companies Act The auditor has the following other duties under the Companies Act: i. Duty of the auditor or a partner of a firm of Chartered Accountants practicing in India to sign audit report (Section 229).

ii. Duty of the auditor to report on prospectus on the accounting part (Section 56). iii. Duty to assist the inspector appointed by the Central Government to investigate the affairs of the company (Section 240).

iv. Duty to report on profit and loss account for the period from the last closing date to the date of declaration of insolvency by the directors and also on balance sheet (Section 488).

v. Duty to certify the statutory report of the company in respect of shares allotted, cash received in respect of such shares and the receipts and payments of the company [Section 165 (4)].

Contractual Duties A professional accountant may be hired by a company for purposes other than the statutory audit. In all such cases, the duty of the auditor will depend upon the terms and conditions of his appointment.

#### Duty to Have Reasonable Care and Skill

An auditor of a company must be honest and must exercise reasonable care and skill to perform his audit work; otherwise he may be sued for damages. It was observed in Kingston Cotton Mills Case (1896) that the

auditor should perform his audit work with such care, skill and caution that is reasonably competent, careful and cautious auditor will use.

Duty of an Auditor Regarding Mandatory Accounting Standards According to the decision of the Council of the Institute of Chartered Accountants of India, it has been resolved that while discharging their functions, it is the duty of the members of the Institute to ensure that the mandatory accounting standards are followed in the presentation of the financial statements covered by their audit report. In the event of any deviation from the standards, it is also the duty of the auditor to make adequate disclosure in their reports so that the users of such statements may be aware of such deviations. Section 227 (3) (d) of the Companies Act also states that the auditor's report shall state whether the

company's balance sheet and profit and loss account comply with the Accounting Standards referred to in Section 211 (3C).

## Duty to the Profession Itself

Every profession has its own code of conduct and professional ethics. The Institute of Chartered Accountants of India has also issued the required code of conduct and professional ethics, which has to be maintained by the members of the Institute. So, it is the duty of the company auditor to follow code of conduct and his professional ethics

### ***LIABILITIES OF COMPANY AUDITOR***

The auditor holds a position of great responsibility and has to perform certain duties, statutory or otherwise, assigned to him. In performing his duties, he has to exercise reasonable care and skill. His client expects him to follow the generally accepted auditing standards and he may be held liable in case he does not act with reasonable care and skill required from him in a particular situation.

The liabilities of an auditor can be described by classifying them under the following categories:

#### Auditor's Liabilities

On the basis of legal

implication

On the basis of nature of liability

Other liabilities

Liabilities under

Companies Act

Liabilities under

Chartered Accountants Act

Liabilities under any Special Act

Civil Liability

Criminal Liability

Liabilities to Third Parties

Negligence Misfeasance

Liabilities for unlawful acts of the Client

Liabilities to Articled Clerks

Liabilities on the Basis of Legal Implications

On the basis of legal implication, liabilities may be divided into three categories, namely: Liabilities

Under the Companies Act Under the Companies Act, the liability of an auditor may arise in the following cases: (a) Misappropriation and Retention of Client's Money

If an auditor has misapplied or retained or become liable or accountable for any money or property of the company, or has been guilty of any misfeasance or breach of trust in relation to the company, the court may compel him to repay or to restore the money or property of or any part thereof with interest at certain rate or to contribute such sum to the assets of the company by way of compensation (Section 543).

(b) Mis-Statements in the Prospectus

He shall be liable with regard to mis-statements in the prospectus of the company under Section 62. The auditor is liable to pay compensation to every person who subscribes for any shares or debentures on the faith of the prospectus issued by the company for any loss or damage he may have sustained.

(c) False Statement in Returns, Reports, etc.

He shall be liable if he makes a false statement with material particulars in returns, reports or other statements knowing it to be false or omits any material fact knowing it to be material (Section 628).

(d) Intentional False Evidence

He shall be liable if he gives false evidence intentionally upon any examination upon oath or solemn affirmations, authorised under this Act or in any affidavit, deposition or solemn affirmations, in or about the winding up of any company under this Act (Section 629).

(e) Liability for Delinquency

The liquidators may prosecute an auditor as an officer of the company during the course of winding up of the company for delinquency (Section 545).

(f) Will full Default in Report Making

He will be held liable if he will fully makes a default in making his report to the shareholders according to the provisions of Sections 227 and 229 (Section 233).

(g) Destruction, Alteration of Books, etc.

If he is found guilty of destruction, mutilation, alteration, falsification or secreting of any books, papers or securities or if he makes any false or fraudulent entry in any register, books of accounts or documents of the company, he may be held liable (Section 539).

(h) Authorising False Statement in the Prospectus

If he authorises the issue of the prospectus of a company containing a false and untrue statement, he will be held liable (Section 63). i. Party to the Issue of Prospectus

He may be held liable if he is party to the issue of prospectus including statement purporting to be made by him as an expert, unless he is not interested in the formation or promotion or in the management of the company (Sections 57, 58 and 59).

(j) Inducing Fraudulently to Invest Money



He will be liable if he induces a person fraudulently to invest money by knowingly or recklessly making a statement or promise, which is false or misleading, or if he dishonestly conceals the material fact (Section 68).

#### Liabilities Under the Chartered Accountants Act

The liability of Chartered Accountant, acting as an auditor, may be in the form of disciplinary proceedings under the Chartered Accountants Act, 1949. It may arise on account of professional misconduct on the part of the auditor.

There are separate provisions for professional misconduct in relation to (a) chartered accountants in practice (b) members of the Institute in service and (c) members of the Institute in general. The Council, under Section 21, refers the case of professional misconduct on the part of the members to the Disciplinary Committee. The latter holds the enquiry and reports its findings to the Council. In case the Council finds, on the basis on its report that the member is guilty of professional misconduct, it gives chance to the member to explain his conduct. On the basis of hearing, the Council takes necessary fictions. But if the misconduct on the part of the member is other than that specified in the First Schedule of the Chartered Accountants Act, 1949, the Council has to refer the case to the High Court with its recommendations thereon.

#### Liabilities Under Any Special Act

In addition to the Companies Act and the Chartered Accountants Act, the auditor is also held liable under different special Acts, which are stated below: (a) Under Banking Companies Regulation Act, 1940 i. Under Section 46 of the Banking Companies Act, 1940, if an auditor in any return, balance sheet or other document, will fully makes a statement, which is false in any material particular, knowing it to be false, or will fully omits to make a material statement, he will be held responsible.

ii. Under Section 45G, an auditor of a banking company may be publicly examined in the winding up proceedings. On such examination, the High Court may make an order, if he is not found fit to act as an auditor, that he will not act as auditor of any company for such period not exceeding five years as may be specified in the order.

(b) Under the Life Insurance Corporation Act Under Section 104 of the Life Insurance Corporation Act, 1956 an auditor may be sentenced to imprisonment or fine, or both, if he gives a false statement knowingly in any return, report or other such forms to be issued under the Act.

#### (c) Under the Indian Penal Code

Under Section 197 of the Indian Penal Code, if any person including auditor issues or signs a certificate required by law to be given or signed, or relating to any fact of which such certificate is by law admissible in evidence, knowing or believing that such certificate is false in any material point, he shall be punishable in the same manner as if he gave false evidence. (d) Under the Income Tax Act Under Section 278 of the Income Tax Act, 1961, if any person including an auditor abets or induces in any manner another person to make and deliver an account, statement or declaration relating to any income chargeable to tax which is false and which he either knows to be false or does not believe to be true, he shall be punishable.

## Civil Liability

The civil liability of an auditor can be for (a) negligence or (b) misfeasance. In these cases, he may be called upon to pay damages as decided by the court.

### (a) Liability for Negligence

An auditor is appointed to perform certain duties. To the extent of his duties as an auditor, he acts as an agent of his client. In this capacity, he must exercise reasonable care and skill to perform his duties for which he is employed. If he acts negligently on account of which the client has to suffer loss, the auditor may be held liable and may be called upon to make good the damages, which the client suffered due to his negligence. It should be noted that if an auditor fails to discover frauds, he might not be failing in his duty. In fact, fraud and other irregularities may not be disclosed by an annual audit and even a detailed audit may not discover certain types of fraud. Under such circumstances, whether the auditor will be held responsible that depends on the fact that whether the auditor should have been able to discover that fraud if he applies reasonable care and skill. If he could, he will be held responsible, otherwise not.

(b) Liability for Misfeasance The term 'misfeasance' implies breach of trust or breach of duty. An auditor has to perform certain duties, which may arise out of a contract with the client as in the case of sole-proprietor or partnership or it may be statutory as laid down under various statutes. The duties of a company auditor have been statutorily laid down in the Companies Act, 1956. If the auditor does not perform his duties properly and as a result his client suffers, he may be held liable for misfeasance. It should be noted that according to Section 543, the court might assess damages against delinquent director or other officers of the company, including an auditor for misfeasance or breach of trust. In the case of an auditor, who also comes within the definition of officer in Section 2 (30) for the purpose of this section, if he is guilty of neglect of duty or misfeasance, so as to causes loss to the company in any way, proceedings may be taken under this section against him either independently or other officers or jointly with them.

## Criminal Liability

An auditor of a company can be held guilty of criminal offences, if he will fully makes a false statement in any report, return, certificate or balance sheet. Under Section 628 of the Companies Act, "if an auditor in any report, certificate, Balance sheet, prospectus, statement or other document required by or for the purpose of any of this Act, makes a statement (a) which is false in any material particular, knowing it to be false or (b) omits any material fact, knowing it to be material, he will be held liable on criminal offence".

Again, Section 197 of the Indian Penal Code provides that whoever issues or signs any certificate required by law to be given or signed or relating to any fact which such certificate is by law admissible in evidence, knowing or believing that such certificate is false in any material point, shall be punishable in the same manner as he gave false evidence. Other Liabilities

The other liabilities of an auditor may include the following: Liability to Third Parties

There are several persons who completely rely upon the financial statements entitled by the auditor and enter into transactions with the company without any further enquiry. These parties may include creditors, the bankers, the tax authorities, the prospective investors etc.

In general, the auditor is not liable to third parties since no contractual obligation exists between the auditor and the third parties. Since they do not appoint him, he owes no duty to them and hence there is no question of any liability to them. He cannot be held liable unless he owes any duty to the persons, who hold him able for damages caused. The third parties, however, can hold him liable, if there has been any fraud on the part of the auditor. Even if there is no contractual obligation between the auditor and the third parties, the latter can sue the auditor if the report of the auditor is of such a nature as amounts to fraud.

#### Liability for Unlawful Act of the Client

An auditor may obtain knowledge about the unlawful acts or defaults committed by his client during the course of his audit. The question arises whether he should form the proper authorities about it and whether he can be held liable if he does not do so. It is a difficult question indeed since it involves breach of confidence placed on him by his client.

Under such circumstances, he must act very carefully. He must not act in such a way, which unnecessarily injures the confidence of his client on him. If required, he should terminate his association with the client rather than open himself to such liability.

#### Liability to Article Clerks

The auditor may be held liable to his article clerks in the following circumstances: i. If he does not act honestly with his article clerk.

ii. If he removes any of his article clerks without any prior notice. iii. If he does not pay the required amount of monthly stipend to the article clerks. iv. If he gives a false certificate of payment of stipend to his article clerks. The auditor, however, cannot be held liable to his article clerks to pay compensation to them in case their services are terminated by the auditor. The question of payment of compensation to a retrenched or dismissed worker arises under the Industrial Dispute Act, 1956 only, which is not applicable to article clerks.



# ***COMPANY AUDIT***

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## ***Company Audit***

***Introduction:*** A company is said to be an artificial person created by law having a separate legal entity distinct from its shareholders. It cannot be directly managed by its owners, i.e., shareholders, because they are very large in number having small holding and also scattered over a wide area. As such, the management and control of the affairs of the company is done by other persons generally known as directors. Hence, it becomes essential for a company to appoint an independent and qualified person, i.e., an auditor, to verify and certify the truth and fairness of the financial statements.

### ***PRELIMINARIES BEFORE COMMENCEMENT OF COMPANY AUDIT***

Before commencing the actual audit work of a company, the auditor should go through the following preliminaries:

Ensuring That His Appointment Is In Order Before accepting the offer for appointment as auditor in a company, the auditor should ensure himself that his appointment is made according to the provisions of Sections 224 and 225 of the Companies Act and whether all the formalities being maintained by the company before giving him the appointment as auditor. The auditor will go through the following:

- i. He should see whether his appointment has been made according to Section 224 (1B) of the Companies Act. For this purpose he will obtain a copy of resolution adopted at board meeting or the shareholders meeting as the case may be.
- ii. If he is appointed in place of a retiring auditor, he will enquire whether due notice was served to the retiring auditor. He will get informed from retiring auditor about the circumstances under which

he has retired and whether he should accept the appointment. This is a professional requirement as per Chartered Accountants Act, 1949.

iii. He should, within thirty days of receipt of appointment letter, inform the Registrar in writing that he has accepted or refused to accept the appointment.

iv. If he is appointed to fill the casual vacancy caused by the death of the previous auditor, he will get the copy of the minutes of the board meeting in this regard and also get the confirmation of death of the previous auditor.

v. He will see that if the company has failed to appoint or re-appoint any auditor in the annual general meeting, the Central Government has appointed him to fill the vacancy.

vi. If he is appointed due to the resignation of the previous auditor he must see that he has been appointed in a general meeting of shareholders. The board of directors will have no right to appoint him under such circumstances.

vii. He will verify whether his remuneration has been fixed according to the provisions of the Companies Act.

#### ***QUALIFICATION OF AN AUDITOR***

Section 226 of the Companies Act prescribes the qualification and disqualification of Company Auditors. According to Section 226 (1), "a person shall not be qualified as auditor of a company unless he is a Chartered Accountant within the meaning of the Chartered Accountants Act, 1949". It further provides that a firm whereof all the partners practicing in India are qualified for appointment as auditors may be appointed by firm's name to be the auditor of the company. In this connection, it may be noted that under the Chartered Accountants Act, 1949 only a chartered accountant having a certificate of practice can be engaged in the public practice of the profession of accountancy. Therefore, only a practicing chartered accountant can be appointed as an auditor of a company. In addition to above, a person, holding a certificate under the law in force in the whole or any portion of a Part B State immediately before the commencement of the Part B States (Laws) Act, 1953 or of the Jammu and Kashmir (Extension of Laws) Act, 1956 as the case may be, entitling him to act as an auditor of the companies in the territories which, immediately before 1 November 1956 were comprised in that state or any portion thereof, shall also be entitled to be appointed to act as an auditor of companies registered anywhere in India.

Thus, the auditor of a company must either be: i. a practicing chartered accountant; or

ii. the holder of a certificate in erstwhile Part B States entitling him to act as an auditor of companies.

#### ***DISQUALIFICATION OF AN AUDITOR***

Section 226 (3) provides the criteria or conditions for disqualification of auditors. According to it, none of the following shall be qualified for appointment as an auditor of a company: i. A body corporate;

ii. An officer or employee of the company;

- iii. A partner or an employee of an officer or employee of the company;
- iv. A person who is indebted to the company for an amount exceeding Rs. 1,000 or who has given any guarantee or provided any security in connection with the indebtedness of any third person; and
- v. A person holding any security of the audit company when such security carries voting right.

A person shall not be qualified for appointment as an auditor of a company if he is, by virtue of Section 226 (3), disqualified for appointment as an auditor of any other company, which is that company's subsidiary or holding company or a subsidiary of that company's holding company. If the auditor ceases to be a member of the Institute of Chartered Accountants of India or adjudged as having unsound mind or is an undischarged insolvent, he attracts disqualification. If after his appointment, an auditor becomes disqualified subject to any of the points listed above, he shall be deemed to have vacated his office as such.

### ***REMOVAL OF AUDITORS***

An appointed auditor may be removed from his office either in accordance with the provisions of the Companies Act or as per restrictions imposed by the Chartered Accountants Act.

#### ***Removal as per the Companies Act***

The removal of the auditor in accordance with the provisions of the Companies Act depends upon the option of the concerned company. He may be removed before the expiry of his term or after the expiry of his term. The service of the first auditor appointed by the Board and supposed to hold office till the conclusion of the first annual general meeting can be terminated beforehand by way of passing a resolution in a general meeting. However, the removal of any subsequent auditor before the expiry of his term is difficult in the sense that it requires the approval of the Central Government as per Section 227 (7). So, the Central Government has to be convinced about the unsuitability of the existing auditor to continue as auditor. The Companies Act lays down clear procedures about the removal of auditors in Sections 224 and Section 225.

#### ***Removal Before the Expiry of the Term***

- i. Under Section 224 (5) (a), it is provided that the company can remove in a general meeting the first auditor appointed by the Board of Directors.
- ii. Under Section 224 (7), it is provided that except the first auditor, auditors appointed as per Section 224 could be removed before the expiry of the term in a general meeting, only after obtaining previous approval of the Central Government.

#### ***Removal After the Expiry of the Term***

The auditor can be removed after the expiry of his term of office, as per the procedures laid down in Section 225. According to the section, for removal of a retiring auditor or appointing another auditor in his place, the following procedures must be observed: i. Special notice must be given by a member of the intended resolution to be passed at an annual general meeting.

ii. On receipt of such a notice, the company shall forward a copy thereof to the retiring auditor. iii. The retiring auditor then may make written representation to the company not exceeding a reasonable length and request their notification to the members of the company.

The company shall, unless the representations are received by it too late to do so

i. state the fact of the representation in any notice of the resolution given to members of the company and

ii. send a copy of the representation to every members of the company to whom notice of the meeting is sent.

If a copy of the representation is not sent as aforesaid, because they are received too late or because of the company's default, the auditor may require that the representation shall be read out at the meeting. However, these are not required, if the Company Law Board is satisfied that the above rights are abused by the auditor.

#### ***Removal as per Chartered Accountants Act***

An auditor may also be removed from his office due to his professional misconduct. Following are some of the important clauses of the Chartered Accountants Act, 1949, which mention the professional misconduct for which a Chartered Accountant may be removed from his office:

i. If a Chartered Accountant accepts the position as an auditor previously held by another Chartered Accountant without first communicating him in writing.

ii. If a Chartered Accountant is grossly negligent in the conduct of his professional duties. iii. If a Chartered Accountant is engaged in any business or occupation other than the profession of accountancy unless permitted by the council of the Institute.

iv. If a Chartered Accountant contravenes any of the provisions of the Act and regulation made there under etc.

#### ***APPOINTMENT OF AUDITORS***

The provisions regarding appointment of the auditors are contained in Section 224 of the Companies Act. First Auditor

Section 224 (5) provides for the appointment of first auditors by the Board of Directors within one month of the date of registration of the company. The auditor or auditors so appointed shall hold office till the conclusion of the first annual general meeting.



But the company may at a general meeting remove such an auditor and appoint another in his place, on a nomination being made by any member of the company, notice being given to the members of the company, not less than 14 days before the date of the meeting. If the first auditor is not appointed by the directors, within one month of registration, the company in general meeting may appoint the first auditor. The auditor of a company is normally appointed by the shareholders by passing a resolution at the annual general meeting. Once appointed, he holds office from the conclusion of that meeting to the conclusion of the next annual general meeting. An auditor once appointed may be reappointed in the next annual general meeting or a new auditor may be appointed in his place. It is obligatory on the part of a company to annually make such an appointment, as well as to give, within seven days of the appointment, intimation to every auditor so appointed or reappointed.

#### Subsequent Auditors

Subsequent auditors of a company are appointed every year by the shareholders in annual general meeting by passing an ordinary resolution. According to Section 224 (1), "Every Company shall, at each annual general meeting, appoint an auditor to hold office". Section 224 (1A) requires the auditor so appointed to communicate his acceptance or refusal to the Registrar of Companies within the period of 30 days of the receipt of appointment order from the company intimating his appointment.

If the auditor so appointed does not accept the appointment, the vacancy can neither be treated as casual vacancy nor a vacancy by resignation. The Research Committee of the Institute of Chartered Accountants of India has clearly expressed this opinion on the strength of the provisions of the Companies Act, which vest the general power with shareholders and the delegation of powers to the Board of Directors is not permitted. Therefore, another general meeting has to be convened to appoint new auditor.

#### Appointment by Central Government

According to Section 224 (3), where at an annual general meeting, no auditors are appointed or re-appointed, the Central Government may appoint a person to fill the vacancy. Within seven days of the power of the Central Government becoming exercisable, the company shall give notice of that fact to the Central Government. Failure to give such notice will make the company in default with a fine, which may extend to Rs. 5,000.

#### Appointment Against a Casual Vacancy

If due to death, insanity or insolvency etc, a casual vacancy of the auditor arises, the Board of Directors can fill the same under Section 224 (6). The auditor appointed against such a vacancy will hold office till the conclusion of the next annual general meeting.

**Appointment by Special Resolution** The Companies (Amendment) Act, 1974 introduced Section 224A, which provides that in the case of a company in which 25% or more of the subscribed share capital is held whether individually or collectively by: i.

a public financial institution or a government company or any state government or

ii. any financial or other institution established by any provincial or state Act in which a state government holds not less than 51% of the subscribed share capital or

iii. a nationalised bank or an insurance company carrying on general insurance business the appointment of the auditor shall be made by a special resolution.

If the company fails to pass a special resolution, it shall be deemed that no auditor has been appointed by the company at its annual general meeting and the Central Government will be empowered to make an appointment.

**Appointment of Auditors of Government or Certain Other Companies** Section 619 provides that the auditor of a government company shall be appointed or reappointed by the Central Government on the advice of the Comptroller and Auditor General of India. The Amendment Act also introduced another section, i.e., Section 619B, which extends the provision of Section 619, to a company in which the Central Government or state government or any government company or any government corporation hold either single or jointly not less than 51% of the paid up share capital.

The professional auditor should keep these provisions in mind while accepting an appointment as the auditor of a company since the onus of complying with the provisions of Section 619B lies with the concerned companies. All the same, it would be necessary on the part of the auditors appointed or re-appointed under Section 224 of the Act to ensure, before accepting the appointment/re-appointment, that the company concerned is in fact outside the ambit of Section 619B of the Act.

### ***TENURE OF APPOINTMENT***

Section 224 (1) of the Companies Act provides that an auditor is appointed from the conclusion of one annual general meeting until the conclusion of next annual general meeting. But, if the annual general meeting is not held within the period prescribed by Section 166, the auditor will continue in office till the annual general meeting is actually held and concluded. So, if an annual general meeting is adjourned, his tenure will extend till the conclusion of the adjourned meeting.

### ***RE-APPOINTMENT OF RETIRING AUDITOR***

According to the provisions of Section 224 (2), retiring auditor, by whatsoever authority appointed, shall be automatically re-appointed by passing an ordinary resolution except in the following circumstances: i. Where he is not qualified for re-appointment.

ii. Where he has given to the company a notice in writing of his unwillingness to be re-appointed. iii. Where a resolution has been passed at the meeting, appointing somebody else instead of him or providing expressly that he shall not be re-appointed.

iv. Where a notice has been given of an intended resolution to appoint some person in the place of retiring auditor, and by reason of death, incapacity or disqualification of that person, the resolution cannot be proceeded with.

The re-appointment will not be automatic. Also, the non-reappointment of the retiring auditor in the annual general meeting is not removal of the auditor. It will be considered simply as retirement.

The auditor will also not be re-appointed in the following two special cases: i. Where he holds the audit of specified number of companies or more than that on the day of appointment in terms of Section 224 (1B) of the Companies Act.

ii. Where 25% or more of the subscribed capital of the company is held by public financial institution(s), government companies etc. or a combination of them, unless the retiring auditor is appointed by a special resolution.

The rights of retiring auditor are as follows: i. He has the right to receive the notice of the resolution.

ii. He has the right to make a written presentation to the company and requests its notification to members of the company.

iii. The auditor has the right to get his representation circulated among the members. iv. He has the right to get his representation read out at the meeting, if it has not been sent to the members because of delay or default on the part of the company.

#### **REMUNERATION OF AUDITOR**

i. In case of an auditor appointed by the Board of Directors or the Central Government, his remuneration may be fixed by the Board of Directors or the Central Government as the case may be.

ii. In all other respect, it must be fixed by the company in general meeting or in such manner as the company in general meeting may determine.

‘Remuneration’ includes any sum paid by the company in respect of the auditor’s expenses in carrying out his duties. Obviously, the general meeting can disperse without deciding the amount of the remuneration of the auditor. However, it must provide the manner in which the remuneration can be determined. If an auditor renders services other than the audit work, he will be entitled to get additional remuneration for such work. A special disclosure of all amount paid to the auditor in whatever capacity is required to be made in the Profit and Loss Account as:

i.as auditor

ii. as adviser, or in any other capacity in respect of a. taxation matters, b. company law matters, c. management services, and

iii. In any other manner.

The aforesaid manner of disclosure is required by Part II of Schedule VI to the Act. Where the auditor is re-appointed in the next annual general meeting, the amount fixed for the previous year continues to be the remuneration of the auditor unless specific changes are made.