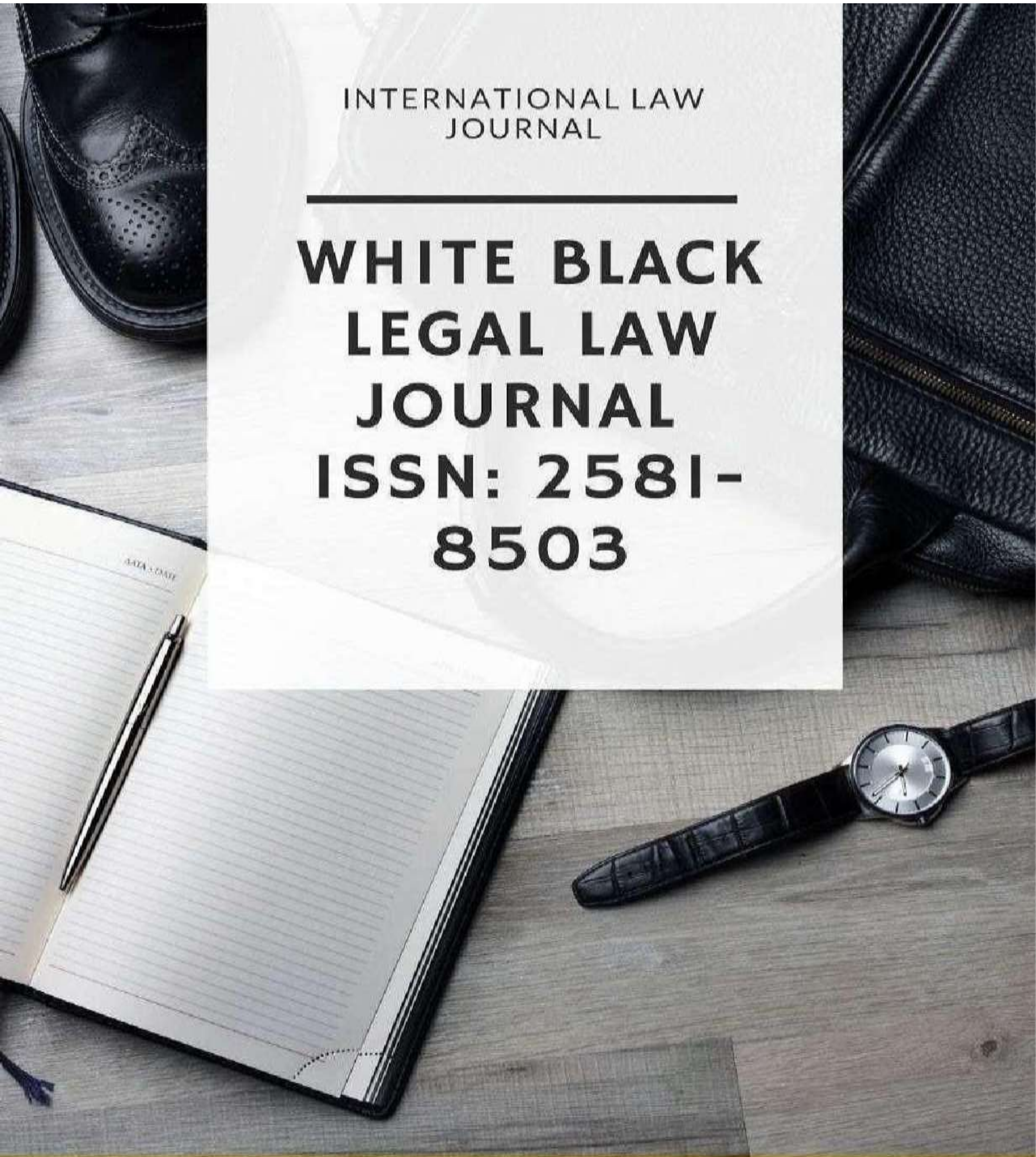

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WHITE BLACK LEGAL is an open access, peer-reviewed and refereed journal providededicated to express views on topical legal issues, thereby generating a cross current of ideas on emerging matters. This platform shall also ignite the initiative and desire of young law students to contribute in the field of law. The erudite response of legal luminaries shall be solicited to enable readers to explore challenges that lie before law makers, lawyers and the society at large, in the event of the ever changing social, economic and technological scenario.

With this thought, w hereby present to you

AUDITOR EXPECTATION GAP -

DEMYSTIFYING TRI-SURE INDIA LTD. VS A.F. FERGUSON AND CO. AND OTHERS.

AUTHORED BY - AISHANI PACHAURI

L.C. Suit no. 1377 of 1978

Decided on October 21, 1985, October 23, 1985 and October 24, 1985

INTRODUCTION

An auditor is a professional who reviews the accounts of a company, analyses, and verifies the accuracy of the said financial statements, and determines if the firm has complied with established standards such as generally accepted accounting principles (GAAP)[1]. The auditors have a fiduciary relationship with the firm's shareholders as their role is very important in corporate governance. However, this often leads to the assumption that the auditors are the absolute gatekeepers and are liable to furnish the stakeholders with the untainted and exact financial records of the firm. This leads to the auditor's role being questioned whenever any manipulation or misrepresentation of the financial statements comes to light. In the present analysis, the role of the auditors and, more importantly, the auditor expectation gap, will be discussed in the light of the case *Tri-Sure India Ltd. vs A.F. Ferguson and Co. and Others.*

FACTS

The plaintiff company, Tri-Sure India Ltd. was incorporated in the United States of America and was a wholly owned subsidiary of American Flange Mfg. Co., dealing in manufacturing of flanges and bungs. American Flange was regularly updated regarding the functioning of the Plaintiffs and monthly financial accounts were sent to the holding company with Mr. Yien as a financial controller. As per the requirement laid down in Section 277 of the Companies Act, 2013, Defendant no.1 reported the accounts of the company which were later approve by the shareholders at the general meeting and subsequently annexed to the prospectus. As per the Report, while 1970-73 showed a uniform upward trend, 1974 and 75 displayed a steep and

[1] Liberto D, 'Auditor' (Investopedia April 1, 2022) <https://www.investopedia.com/terms/a/auditor.asp> accessed April 7, 2021

abnormal rise in the profits and there was over-subscription of public issue. Singaravelu, head of the purchase department of the Plaintiffs, acted as a whistleblower and informed one of the directors, Mr. C.J.E. Grundy, that the staff had manipulated the accounts of financial year 1974-75 in order to present large sales. The same was further communicated to Mr. Parish and Mr. Wheaton who were both directors of the plaintiff as well as the holding company. The latter visited Bombay to look into the matter and the former advised Defendant no.1 to carry out confidential investigative audit. Mr. Wheaton, in the presence of K. Shankar Hegde who was the managing director, carried out the inspection and meanwhile, during the investigation conducted by Defendant No. 1, multiple irregularities came into light and Defendant No. 1, therefore, extended the investigative audit in respect of the previous year's accounts. Finally the investigative audit showed that the financial accounts were manipulated by K. Shankar Hedge along with the heads of company's several departments. The Plaintiffs consequently offered to refund the money along with interest rate to the allottees who subscribed the shared offered on misrepresentation.

PLAINTIFFS

The Plaintiffs claimed that they suffered damages due to the negligence on the part of the Defendants and furthermore, income tax returns were filed by the Defendant no.1 and a higher income tax had to be paid by the plaintiff due to the inflated figures as the Defendant didn't ask the tax authorities to withhold the assessment orders over the incorrect reports. The Plaintiffs served a notice demanding damages which was declined by the Defendant subsequently leading the Plaintiffs to institute the suit for recovery of sum a of Rs. 63,84,792 with 16% per annum interest rate from the date of the suit till recovery as well as the costs of the suit from the Defendants.

All five departments' heads of the plaintiff company along with the M.D., Hegde, were collectively manipulating the financial accounts and Mr. Parish accepted that he holds them guilty of the same and that they all have admitted their actions. One of the heads agreed to cooperate with the auditors and admitted to have falsified auditor's marks which was supposed to indicate that a particular entry has been checked by the auditor.

DEFENDANT

The Defendants contented that there was no negligence in their work and that the auditing process was carried out as per the rules of accountancy. Furthermore, the figures which were accepted by the auditors were also accepted by the board of directors of the plaintiff company as well as the officers of the American and so were the explanations provided by the staff of the plaintiff. The Defendants asserted that the plaintiff are merely accusing the Defendant of negligence in order to find a scapegoat to mask their own failures as the fraud was committed by the company's managing director along with other heads and the staff. Moreover, the income tax officer passed his order long before Mr. Parish contacted the Defendants regarding the request to undertake the confidential investigative audit.

ANALYSIS

While the case covers various issues, it majorly discusses the extent of the duties of an auditor. Despite it being evident that it was the management of the company from various levels which was guilty of manipulating the books of accounts, the plaintiff blames the auditors for negligence and incapability to point of the discrepancies when the fraud came into light.

The provisions in regards with the auditors in India are stated in Section 139 to 148[2] of the Companies Act, 2013, along with Companies (Audit and Auditors) Rules, 2014 and Companies (Accounts) Rules, 2014. An auditor's general duty involves providing a general assurance by pointing out any material discrepancies, adhere to audit standards, undergo fraud risk assessment and formulate counter strategies for the same. Given that even the security register had been tampered with, it is apparent that the fraud and the misrepresentation was rooted to a great extent and the management's shortcoming is clearly evident. The auditor's involvement does not discharge the management from their duty. The Hon'ble Judge also referred to the *The International Auditing Guideline No. 1* which says that while the auditor is liable for providing his opinion on the financial statements of a company, it is the management's responsibility to prepare the said accounts. According to the guideline, the auditor's duty is to assess if these records are reliable by analysing the accounting system as well as the internal control system of the company.

An auditor is dutybound to show basic prudence while carrying out this verification. However, the issue arises here is to what extent is the auditor liable and what can be considered negligence. On drawing parallel with other professions, such as medical, it is well established that the rule for

[2] The Companies Act 2013, s. 139 – s. 148.

determining whether standard of care was taken or not is based on whether the defendant was exercising ordinary skill of an ordinary man[3] and that in itself is sufficient to carry out the task. Moreover, the burden of proof lies on the plaintiff to prove that the negligence shown by the professional lead to the injury. The Hon'ble Judge brought up the 'but-for' test which demands that the negligence should be the cause of damage and quoted *McWilliams* v. *Sir William Arrol and Co. Ltd.*[4] for the same. Furthermore, the situation should be such that the plaintiff holds the knowledge which would have made an ordinary prudent man in his shoes to realize the threat. While the auditor needs to verify the company's state of affairs, he is not required to play detective. The NFRA Chairperson's recent statement while defining the role of an auditor - that the belief that the auditors are 'watchdogs and not bloodhounds' needs to be departed from[5] - is along similar lines of the plaintiff's contention. However, in the present case, the Judge stressed on the 'compliance test' and held that unless and until the circumstances require the auditor to take extra caution, it is not expected of them to conduct a start to end thorough forensic investigation as it is unrealistic and is not required by International Auditing Guidelines No. 6. Since even the directors approved the financial statements, and found no need to suspect misrepresentation, it cannot be expected of the auditors to do the same. The Judge placed reliance on *Richard Laurence Parish (Jr.) v. Registrar of Companies*[6] for the same. In another case, *Union Of India vs R.N. Rajam Iyer And Anr., 1964*[7], the blame was put on the auditor for not pointing out the discrepancies and being negligent but the Council of Institute of Chartered Accountants (ICAI) refuted the claim and held that given that since even the directors failed at recognizing the fraud, the auditor cannot be held for being negligent.

For quite a while, accountants and corporate executives have argued over the flexibility and autonomy provided to the auditors. While the accountants contend that executives hinder the smooth functioning of the auditing process, the executives contend that there is a need to keep a check on the auditors as they can show gross negligence. This gap between what the stakeholders of a company believe the duties of an auditor involve, and what the auditors believe regarding the matter, is known as auditor expectation gap. In the given case, the extent of the auditor's duties and where they can be held negligent was deeply debated over. This common misconception

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[3] Halsbury's Laws, "*General Principles of the Law of Negligence*" (4th edn) vol 34, para 10
[4] [1962] 1 WLR 295 (HL)
[5] Speech of R. Sridharan, Chairperson, NFRA, as Chief Guest at the 35th Regional Conference of the Western India Regional Council of The Institute of Chartered Accountants of India on Dec. 24, 2020 para 33 pg- 16 <https://nfra.gov.in/sites/default/files/WIRC%20Speech_1.pdf >
[6] *Richard Laurence Parish (Jr.) v. Registrar of Companies* [1983] 54 Comp Cas 197
[7] *Union Of India vs R.N. Rajam Iyer And Anr.* AIR 1964 Mad 398

where auditors are considered absolute gatekeepers and are expected to do thorough forensic analysis of the financial records leads to the auditor's to be blamed for any manipulation of the said records. This leads to auditors facing over-regulation which hampers the spirit of the job. In order to protect the auditor's position while simultaneously balance the investor's and the management's interest, the auditor expectation gap needs to be taken into consideration. Attempts were made by the Companies Act to place reasonable limitations on the auditors while also granting them sufficient flexibility so they can achieve efficiency in the auditing process. However, when the Satyam scandal or the Enron fraud came into light, the auditor expectation gap was ignored, and the auditor's role and honesty was questioned. This led to a major overhaul in the Companies Act and the ministry of corporate affairs (MCA) was conferred with more power. An independent body, National Financial Reporting Authority (NFRA), was established under Section 132 of CA[8] which was to take over the penal powers which were earlier exercised by the ICAI and regulate the auditors. The ICAI would maintain regulating the auditing standards and the Auditing and Assurance Standards Board under them would formulate certain standards as per International Auditing and Assurance Board (IAASB)[9]. Moreover, when the listed companies were allegedly affected due to the lapses by auditors, Securities and Exchange Board of India (SEBI) also took charge. The MCA also introduced quota imposition according to which the government was given the power to fix how many audits a firm can take up. Additionally, section 177(4) of the Companies Act, 2013[10], read along with Listing Obligations and Disclosure Requirements (LODR) Regulations[11] laid down the terms of Audit Committee as well as their duties which included monitoring appointments and functioning of the auditors by keeping a close eye on their independence, financial control system and risk management.[12] It is due to such scandals that the concept of 'guarding the guards' came into spotlight and a variety of provisions were introduced leading to over-regulation of the auditors.

CONCLUSION

The Hon'ble Judge held that the plaintiff failed to establish any damages suffered due to the negligence of the Defendant. No negligence was seen on part of the Defendants and are, therefore,

[8] The Companies Act 2013, s. 132.
[9] Jayshree P. Upadhyay, 'The fight to fix the fault in our audits', Livemint (Mumbai, 24 February 2020)
[10] The Companies Act 2013, s. 177(4)
[11] Listing Obligations and Disclosure Requirements (2015)
[12] Kataria, CA Naresh, 'Corporate Frauds in India – Part III' (*Corporate frauds in India* May 4, 2021) http://www.lawstreetindia.com/experts/column?sid=488 accessed April 3, 2022

not liable to pay any compensation. The court evidently took the auditor expectation gap into consideration and moreover, identified that the firm was merely filing the suit in order to use the Defendant as a scapegoat to cover up the fraud and evade their responsibility. An auditor does not relieve the management from their responsibility and are not the absolute gatekeepers reviewing every detail with a detective outlook. They cannot be expected to point out every single minute discrepancy in the company's financial accounts, more so when the said accounts have been intentionally tempered with by the management itself without arousing any suspicion. Managing expectations and viewing auditing in a realistic point of view is very important in order to secure the interest of not just the auditor but also the stakeholders of the company.