
(1960) ILR (Mad) 55

Madras High Court

Case No: None

The Council of the
Institute of Chartered
Accountants of India,
Referring Authority

APPELLANT

Vs

V. Rajaram of V.
Rajaram and Co.

RESPONDENT

Date of Decision: July 30, 1959

Citation: (1960) ILR (Mad) 55

Hon'ble Judges: P.V. Rajamannar, C.J; Ganapatia Pillai, J

Bench: Division Bench

Judgement

P.V. Rajamannar, C.J.

This is a reference to us u/s 21(2) of the Chartered Accountants Act on the report of the Disciplinary Committee of the Council of the Institute of Chartered Accountants of India in proceedings taken against the respondent auditor on a complaint preferred by the Central Government in the following circumstances. The respondent is a member of a firm of Chartered Accountants in Madras, who were appointed auditors of the Adambakkam Janopakara Saswatha Nidhi Ltd., carrying on business in Alandur.

The audit related to the period ending 31st March 1957. The actual audit was done by V. Rajaram the respondent, a partner of the audit firm. In the audit report by the respondent dated 31st May 1957, we find the following statement:

We have not verified the securities and documents relating to the Book Debts, but have accepted the report of the Special Examiners who were appointed for the purpose by the Directors.

To understand this it is necessary to refer to Article 103 of the Articles of Association of the Nidhi. That runs as follows :

The Secretary shall appoint every year two persons either from the directors or from the members to examine the title deeds, documents and other records in respect of Immovable properties mortgaged and jewels and cash balances in possession of the Nidhi and to inspect the properties, and the said examiners shall inspect the properties personally and make a report thereon within one month preceding the annual general meeting of the Nidhi

The charge against the respondent was that he had failed to discharge one of the important duties of an auditor, namely, the verification of the assets of the company. It was not sufficient for the auditor merely to verify the correctness of the balance sheet as shown by the books; he should verify by actual inspection or by other evidence at his disposal the existence of the assets. It was not enough for the auditor to make the qualified report in the manner above mentioned. The respondent was therefore guilty of gross negligence in the discharge of his professional duties within the meaning of Clause (1) of the Schedule to the Chartered Accountants Act. So ran the complaint,

2. The respondent submitted that he had accepted the report of the special examiners appointed by the Board of Directors in accordance with Article 103 cited above and that he had clearly stated in" the report that he had not himself verified the securities and the documents relating to the book debts. He submitted that in doing so he was only acting in accordance with the practice prevalent in the matter of audit of such institutions, that is, Nidhis, and was under a bona fide belief that in view of Article 103 of the Articles of Association of the company, he was entitled to rely upon the certificate of the special examiners in the matter of the verification of the securities. The respondent pleaded therefore that he had acted with reasonable care and diligence and he was not guilty of any misconduct under Clause (q) of the Schedule to the Act.

3. The Disciplinary Committee of the Council held that the fact that the company had provided for internal check for the purpose of verifying the securities would not absolve the auditor from doing what was undoubtedly one of his duties, namely, to himself verify the securities. The committee was unable to find a universal practice of the auditor placing reliance on the report of the special examiners appointed by the company, but was willing to accept that there were instances in which that practice was being followed.

The Committee was, however, clear on this point, namely, that even if such practice was in vogue, it was not a correct practice, and the duty of an auditor in regard to the verification of assets, which is an onerous duty, cannot be deemed to be sufficiently discharged by not doing that duty, so to say, and by relying on the report of any person or persons appointed by the company itself to conduct an internal check. The Committee concluded thus :

... this practice followed by some of the auditors in the case of Nidhis, of not doing the verification of the securities, themselves, but of relying upon the verification done by special examiners, is a wholly improper practice, and it must be discontinued forthwith.

This practice is not in conformity with the audit procedure and responsibilities of an auditor.

We have heard Mr. R. Ramamurthi Aiyar, learned Counsel for the Institute of Chartered Accountants, and the learned Counsel for the respondent auditor and we are happy to say that both were agreed on what should be the duty of an auditor. That is that he should himself verify the assets of the company of which he had been appointed auditor.

4. Mr. Swaminathan, learned Counsel for the respondent drew our attention to passages in one of the leading text books, Spicer and Pegler's Practical Auditing which dealt with internal audit and the relationship between the internal auditor and a statutory auditor. At page 25 of the 12th Edn. of this book, the following passage occurs; and Mr, Swaminathan placed reliance on it:

There also exists considerable scope- for mutual assistance between the two auditors in the planning of their respective audits. Where the statutory auditor is satisfied that the internal auditor has adequately covered part of the work which the statutory auditor would otherwise do, he may be able to reduce the extent of his examination of detail; and consultation between the two auditors may enable the internal auditor to refrain from carrying out work which he would otherwise do but which, having regard to the examination which the statutory auditor considers he must make in any event would result in duplication.

This passage must be understood in the proper context by the distinction which the learned authors themselves make between internal check and internal audit. The internal check is most often carried out by the employees or directors of the company and it consists in checking the day to day transactions which operate continuously as part of the routine system. The internal audit is conducted by a qualified auditor, only, these auditors are generally in the employment of the company. They are not independent auditors.

Indeed the learned authors pointed out that one of the duties of an internal auditor would be to see how far the system of internal check is operating satisfactorily. It is also pointed out that even when there is an internal auditor, it is for the statutory or independent auditor to decide whether and to what extent he can rely on the work of the internal auditor in order to reduce the extent of his own examination of detail, and his decision will depend upon his judgment on the facts of each case, having regard in particular to the extent and efficiency of the internal audit, the experience and qualifications of the chief internal auditor and his staff and the character of their reports, and the authority vested in the chief internal auditor.

We are not concerned in this case with the mutual relation between an internal auditor and an independent statutory auditor because it cannot be said that the special examiners appointed under Article 103 of the Articles of Association of the company are in any sense internal auditors.

5. Mr. Ramamurthi Aiyar drew our attention to a passage in the Principles and Practice of Auditing by T. R. Batliboy, 9th Edn. in which emphasis is laid on the auditor's duty in verifying the assets. The auditor's duty in verifying the assets is two-fold.

He must satisfy himself that they really existed at the date of the balance-sheet and were free from any charge, and that they have been properly valued.

In Spicer and Pegler's Practical Auditing it is pointed out that the verification of loans on security involves not only an examination of the loan account in the ledger, but also of the security lodged, in order that the auditor can satisfy himself that the loan is properly secured, and that there is a reasonable margin between the amount of the loan and the value of the security. These duties are also adverted to at length in [Controller of Insurance Vs. H.C. Das](#), by the Calcutta High Court. Referring to verification of cash this Court had occasion to point out the duties of an auditor in R. G No. 56 of 1051.

We had there observed that the mere certificate from the Managing Agents that they had cash with them could not absolve an auditor from his duty to make the verification himself, and the method of verification which only consisted in accepting the report of the Managing agents is against the accepted audit practice and principle.

6. We are in entire agreement with the observations of the Disciplinary Committee in condemning the practice which appears to exist in respect of the audit of several Nidhis, viz., the auditor not doing verification of securities himself but relying upon the verification done by special examiners appointed by the company itself. It follows that we disapprove of the conduct of the respondent auditor in certifying that he had himself not verified the securities and documents relating to the book debts but had accepted the report of the special examiners who had been appointed for the purpose by the directors.

7. Obviously there is no question of mala fides in this case. There is evidence that a practice did exist in regard to some of the nidhis at any rate of accepting the report of the special examiners. It is not suggested that there was any collusion between the auditor and the directors of the company. In these circumstances, apart from expressing our disapproval, we do not think that the case calls for the award of any punishment as such to the respondent-auditor.