

# IV. AUDITING AT THE CROSSROADS: UNPACKING AMBIGUITIES AND NAVIGATING LEGAL GAPS IN AUDITOR LIABILITY IN INDIA

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## ABSTRACT

Auditors have held a fundamental position in the corporate realm since the old-age Companies Act, 1956 which proves that their role has been crucial since the start. With the advent of improving financial literacy in India and a plethora of new-age investors on a lookout for ventures to invest in, auditors are increasingly acquiring an even more intricate position in the corporate arena as their reports provide credibility to the financial statements of a business. Owing to their extremely integral role, the threshold of liability on them shall be decided with utmost care and diligence. However, we observe that this threshold is dwindling with courts attaching extremely high level of liability in some cases meanwhile being significantly lenient in other instances. This paper explores these ambiguities in the legal arena and the challenges arising out of the differing interpretations by NFRA and ICAI under the Companies Act, 2013. Secondly, it aims to present the trajectory of the precedents in an aligned manner while manoeuvring through the complex standards and the arising impact out of the same. Thirdly, this paper compares the global position by analysing the liability standards in UK, USA and Australia and sheds light on the challenges that India faces in balancing the stringent measures. Lastly, this paper attempts to bring forward a suggestive framework to create a robust financial ecosystem by addressing the gaps in auditing standards and bridging it with least possible disruption in the corporate landscape.

**Keywords:** Auditor, Liability, Audit Report, Negligence, Financial Statements

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## I. INTRODUCTION

*“The auditor is a watchdog and not a bloodhound.”*

- Lord Justice Topes<sup>1</sup>

However, the Companies Act, 2013 (“**The Act**”) does not seem to echo this thought. The recent stringent actions by the courts underscore that the law expects auditors to function as bloodhounds in the discharge of their duties, rather than mere watchdogs.

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<sup>1</sup> CS Dhanapal, ‘Liability of Auditors under the Companies Act, 2013’ (*CA Club India*, 30 November 2013) <<https://www.caclubindia.com/articles/liability-of-auditors-under-the-companies-act-2013-19092.asp>> accessed 03 January 2025.

An auditor is an individual who is hired by a business to examine its financial affairs and offer statements of accuracy.<sup>2</sup> Auditors play an increasingly significant role in establishing the market value of a company by establishing a guarantee that their presented financial data is reliable. At the same time, they are obligated under the law to perform auditing tasks with utmost care and diligence and are expected to adhere to auditing norms and regulations under the prevailing law. With the rapid growth and increasing complexity of the financial landscape, there is also a rise in a plethora of financial scams under scrutiny. The judicial pronouncements have stirred debate over the standards of professional conduct that auditors must uphold and the corresponding liabilities that ought to be affixed to them.<sup>3</sup>

Through this paper, we aim to analyse this muddled position and draw attention to the need for a balanced approach by clarifying the ambiguity surrounding the threshold of liability for auditors and audit firms. Firstly, the paper delves into the issue of auditor independence, particularly examining the dilemma created when auditors simultaneously provide management services, which risks compromising their objectivity and potentially amplifying their liability. Secondly, it outlines the existing legal framework governing auditor accountability in India, with a focus on statutory provisions, regulatory norms, and notable judicial precedents. Thirdly, the paper evaluates the growing significance of the auditor's role in contemporary corporate governance, where their responsibilities extend beyond financial reporting to upholding corporate integrity and investor trust. Fourthly, it analyses the test of

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<sup>2</sup> Daniel Liberto, 'Auditor: What it is, 4 types and qualifications' (*Investopedia*, 4 June 2024) <<https://www.investopedia.com/terms/a/auditor.asp>> accessed 01 January, 2025.

<sup>3</sup> Ayushi Notani, 'Right, Duties and Liabilities of an Auditor under Companies Act, 2013' (*Legal Services India*) <<https://www.legalserviceindia.com/legal/article-17508-rights-duties-and-liabilities-of-an-auditor-under-companies-act-2013.html#:~:text=As%20per%20the%20Companies%20Act,suffers%20losses%20as%20a%20result.>>> accessed 05 January 2025.

negligence applied in fixing auditor liability, tracing its evolution from historical standards to the modern legal framework.

Fifthly, the discussion turns to the complexities introduced by recent judicial pronouncements and regulatory directives, such as the NFRA Circular, which have blurred the boundaries regarding an auditor's liability post-resignation. Sixthly, the paper unravels the multifaceted impacts of this legal uncertainty on auditors, audit firms, companies, and the broader financial ecosystem. Seventhly, a comparative analysis is undertaken to study international practices relating to auditor liability in jurisdictions like the UK, the US, and Australia, to draw lessons for the Indian context. Lastly, the paper concludes by proposing a suggestive framework that seeks to strike a balance between ensuring accountability and preserving the independence and professional discretion of auditors in India.

## **II. AUDITORS' INDEPENDENCE & LIABILITY: THE DILEMMA OVER PERFORMING MANAGEMENT SERVICES**

There exists confusion over what constitutes management services and what activities are non-audit services under Section 144<sup>4</sup> of the Companies Act, based on the different views taken by ICAI and NFRA. These regulators exercise their jurisdiction differently on the basis of the categories of companies, however, different interpretations due to a company falling under the jurisdiction of a different regulator shall not be the norm.

### ***A. Provision of the Act and the view taken by the committee of experts***

The Act states that an auditor shall not provide any non-audit services, either directly or indirectly, to its client, as there exists a risk of conflict of interest in such situations. Hence, under Section 144, management services

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<sup>4</sup> The Companies Act 2013, s 144.

are included as one of the entries under the list of non-audit services. In this backdrop, a Committee of Experts was formed by the Ministry of Corporate Affairs, which was of the view that activities that are prohibited ‘management services’ shall involve an element of performing management functions.<sup>5</sup>

### 1. ICAI INTERPRETATION

The Code of Ethics, 2019, serves as the source from which ICAI has developed its understanding of ‘management services’. It prohibits the auditor from assuming ‘management responsibility’.<sup>6</sup> ICAI’s view seems to be in line with existing international standards, as even the understanding of the International Ethics Standards Board for Accountants (“**IESBA**”)<sup>7</sup>, a board of professional accountants based in New York, seems to be of the opinion that a prohibited management service includes activities which involve taking on a management responsibility.<sup>8</sup>

### 2. POSITION TAKEN BY THE UNITED STATES SECURITIES AND EXCHANGE COMMISSION

In the United States, the Securities and Exchange Commission (“**SEC**”) is the premier independent federal agency, known to have very stringent standards for auditors’ independence. It has taken the view that activities which are performed by the management of the company will only be

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<sup>5</sup> Ministry of Corporate Affairs, *Finding and Recommendations on Regulating Audit Firms and the Networks*, October 2018.

<sup>6</sup> The Institute of Chartered Accountants of India, ‘Code of Ethics, 2019’ (ICAI, 17 January 2019) <<https://kb.icai.org/pdfs/PDFFile62cd69ef8e90a7.27171993.pdf>> accessed 10 January 2025.

<sup>7</sup> Vinati Kastiya & Ayush Tandon, ‘Auditor Independence : The Confusion over Management Services’ (*Economic Times*, 25 September 2022) <<https://cfo.economictimes.indiatimes.com/news/auditor-independence-the-confusion-over-management-services/94438716>> accessed 08 January 2025.

<sup>8</sup> ‘IESBA reinforces Auditor Independence provisions; further limits exceptions and clarifies guidance around non- assurance services’ (*Ethics Board*, 14 April 2015) <<https://www.ethicsboard.org/news-events/2015-04/iesba-reinforces-auditor-independence-provisions-further-limits-exceptions-and-clarifies-guidance>> accessed 11 January 2025.

prohibited and will attract sanctions, however, it does not take into consideration any services which are being provided, including those provided to the management of the company.<sup>9</sup>

### 3. NFRA INTERPRETATION

The NFRA has been publishing the Audit Quality Reports (“AQR”) since 2019, wherein its recent AQR Report of July 2022 has taken a view to interpret the word ‘management services’ in a relatively broader sense.<sup>10</sup> Under the ICAI interpretation, the service being provided to the management of the company was not treated as management services; however, the NFRA, in its broad interpretation, went ahead to include any service rendered to the management of the company as a management service and hence *a prohibited non-audit service*.

This view taken by the NFRA seems to be overly broad and does not align with the prevailing international standards. Moreover, this broad interpretation contradicts the one taken by the ICAI as well as by the Expert Committee. This is resulting in a situation where due to different interpretations taken by the NFRA and ICAI, an activity which though ordinarily is not a prohibited management service, might come under the purview of prohibited management services based on the broad interpretation taken by the NFRA and the auditor may be held liable for violation of Section 144 of the Act, and further be penalised under Section 147 of the Act.

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<sup>9</sup> Vinati Kastiya & Ayush Tandon, ‘Auditor Independence : The Confusion over Management Services’ (AZB & Partners, 26 September 2022) <<https://www.azbpartners.com/bank/auditor-independence-the-confusion-over-management-services>> accessed 05 January 2025.

<sup>10</sup> National Financial Reporting Authority, *Audit Quality Review Report*, June 2022.

### III. AUDITORS' ACCOUNTABILITY: THE EXISTING LEGAL POSITION

The Act, along with Company Rules and other statutes, extensively deals with the rights, duties and liabilities of the auditors. The rights and duties of the auditors are discussed in Section 139<sup>11</sup> to 148<sup>12</sup> of the Act. The liabilities on the auditors can be imposed for breach of rights and duties of auditors, which includes the obligation on the part of the auditors to report fraud under Section 143(12)<sup>13</sup> of the Act, which can be both civil and criminal, where the major difference in treating the violation as civil or criminal seems to be the intention to defraud on the part of the auditors, which is evident from a bare reading of the proviso of Section 147<sup>14</sup> of the Act, which states that the nature of the same will change from civil to criminal if the action is done “*knowingly or wilfully with the intention to deceive the company.*”

As we explore the scope of liability, it includes monetary fines which extends up to lakhs of rupees as well as multiples of the remuneration being provided to the auditor when the violation is civil, however, if the proviso stated above is satisfied, then to further penalise the auditor, the monetary fines increase multi fold to Rs. 25 lakhs and remuneration to up to eight-time A combined reading of Section 140(5)<sup>15</sup> and Section 447<sup>16</sup> of the Act, it deals with situations relating to fraud, and provides that an auditor may be held liable for imprisonment for a term of up to 10 years. Additionally, might also be rendered ineligible for their appointment as an auditor of any company for a period of up to five years.

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<sup>11</sup> The Companies Act 2013, s 139.

<sup>12</sup> The Companies Act 2013, s 148.

<sup>13</sup> The Companies Act 2013, s 143(12).

<sup>14</sup> The Companies Act 2013, s 147.

<sup>15</sup> The Companies Act 2013, s 140(5).

<sup>16</sup> The Companies Act 2013, s 447.

Apart from the liability under the Act, auditors can be held liable for civil damages if they are found to be guilty of committing negligence or misconduct in the performance of their duties, as well as under the penal provisions. This gives us a clear idea that there exists an extensively robust mechanism to punish the auditors in case of violation, which may even extend to making them ineligible to be an auditor.

#### **IV. EVALUATING THE GROWING SIGNIFICANCE OF AUDITORS' ROLE**

The famous *Enron accounting scam of 2001* acted as a wake-up call and stressed the importance of auditors and exemplifying the need for transparent financial reporting.<sup>17</sup> Later came its Indian counterpart, the *Satyam Case of 2009*, the largest corporate fraud of its time in India<sup>18</sup> which shifted the spotlight on the lack of auditing standards across the industry and highlighted the dire need for companies to engage in ethical accounting practices by the companies.

These two scandals heightened the realisation of the need to have an efficient corporate governance framework and prompted the government to devise rules and regulations for making auditing practices fair and standardised. This led to various amendments being made in the Companies Act of 2013, as well as the introduction of the Companies (Audit and Auditor) Rules in the year 2014<sup>19</sup> to ensure that the company's financials are correctly recorded and reported, and to cast various duties upon the auditors. Moving forward to further improve accounting standards and to protect public interest,

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<sup>17</sup> William W. Bratton, 'Enron, Sarbanes-Oxley and Accounting: Rules versus Principles versus Rents' (2003) 48 (4) Villanova LR 1023.

<sup>18</sup> Madan Lal Bhasin, 'Corporate Accounting Fraud: A Case Study of Satyam Computers Limited' (2013) 2(2) OJA <<https://www.scirp.org/journal/paperinformation?paperid=30220>> accessed 15 January 2025.

<sup>19</sup> The Companies (Audit and Auditor) Rules 2014.



the Government in 2018 established the National Financial Reporting Authority (“NFRA”).<sup>20</sup>

All these measures were undertaken in light of the increasing importance of auditors, as they are, in the present day, not only involved in financial reporting but also act as a pillar in ensuring corporate integrity and investor trust by upholding ethical standards and transparency. Furthermore, with the advent of various technologies like blockchain and NFTs and increased inclination of people in the stock market, it is even more significant, as they act as keystones, which are responsible for ensuring that ethical practices are being followed in the company, and if not, to report any irregularities.

## **V. ANALYSING THE TEST OF NEGLIGENCE FOR AUDITORS’ LIABILITY: COMPARISON OF HISTORICAL AND MODERN FRAMEWORK**

In the wake of major corporate scandals that have shaken India's financial landscape, the role of auditors has come under intense scrutiny, and the view taken in *In Re Kingston Cotton Mills*,<sup>21</sup> that an auditor is "a watchdog and not a bloodhound" is increasingly being challenged, as in the case of *ICAI v. P.K. Mukherjee*,<sup>22</sup> which held that the auditors have a “clear duty towards the beneficiaries to probe into the transactions.”

### ***A. Historical Framework***

Historically, Indian courts have employed a lenient approach where intention was a precursor, as evident from cases like *ICAI v. Rajaram*,<sup>23</sup> where

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<sup>20</sup> Robin Banerjee, ‘ICAI vs. NFRA: What’s the fuss all about?’ (*Economic Times*, 28 October 2024) <<https://cfo.economictimes.indiatimes.com/news/tax-legal-accounting/icai-vs-nfra-whats-the-fuss-all-about/114680981>> accessed 16 January 2025.

<sup>21</sup> *In Re: Kingston Cotton Mills Case*, (1896) 2 Ch 279 at 288.

<sup>22</sup> *The Institute of Chartered Accountants of India v. P.K. Mukherji*, AIR 1968 SC 1104.

<sup>23</sup> *Council of the Institute of Chartered Accountants of India v. V Rajaram*, (1959) SCC Online Mad 107 (Mad HC).

the court, despite discovering failure of the auditor to verify cash statements independently, merely expressed its disapproval rather than imposing severe penalties, relying upon the implied understanding that it is an unsaid practice to rely on the company's internal records. However, with time, this approach began to shift, with cases like *Deputy Secretary, Government of India v. S.N. Das Gupta*,<sup>24</sup> where the court recognised the broader implications of auditor negligence and held that the absence of active concealment was immaterial in determining professional misconduct, effectively lowering the threshold for establishing liability.<sup>25</sup>

### ***B. The Modern Framework: Stricter Standards and Enhanced Scrutiny***

The contemporary approach to auditor liability in India has been shaped by several significant developments, most notably the Supreme Court's decision in *ICAI v. Mukesh Gang*.<sup>26</sup> Here, the consideration of intentional wrongdoing was done away with and rather, they constituted negligent duty as direct gross negligence to implicate the auditor. The court reasoned that if the auditor was to be acquitted, it would encourage others to indulge in such scandalous activities and would result in bringing the profession of auditors under the lens of scrutiny and raise questions about their integrity.

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<sup>24</sup> *Deputy Secretary, Government of India v. SN Das Gupta*, (1955) AIR 1956 CAL 414.

<sup>25</sup> MP Ram Mohan & Vishakha Raj, 'Auditors' negligence and professional misconduct in India: a struggle for a consistent legal standard' (2020) IIM Ahmedabad Working Paper No. 2020-09-01 <<https://www.iima.ac.in/sites/default/files/rnpfiles/17803616202020-09-01.pdf>> accessed 08 January 2025.

<sup>26</sup> *The Institute of Chartered Accountants of India v. Mukesh Gang*, AIR Online 2016 HYD 17.

## VI. BLURRING OF BOUNDARIES DUE TO THE JUDICIAL PRONOUNCEMENTS AND THE NFRA CIRCULAR: LIABILITY OF AN AUDITOR POST RESIGNATION

Section 140(5)<sup>27</sup> of the Act states that if an auditor is found to be acting in a fraudulent manner or abets or colludes in a fraudulent act, then the tribunal may direct the company to change its auditors. The constitutionality of this section was initially challenged in the *Deloitte BSR case* of the Bombay High Court,<sup>28</sup> where auditors were accused of failure to detect financial irregularities in the company's accounts. The court held that once an auditor resigns, they are no longer liable for the company's affairs and cannot be held accountable.<sup>29</sup> However, the Supreme Court, rejecting the rationale, held that when proceedings under Section 140(5) had been initiated before the auditor's resignation, such a resignation will not absolve the auditor of the consequences arising out of the negligence during the course of their employment.<sup>30</sup> This set a precedent for holding auditors accountable for not only errors in judgment but also for the lack of due diligence in uncovering such fraudulent acts during the course of their employment, even after their resignation.

In the backdrop of these contrasting judgments, came the National Financial Reporting Authority ("NFRA") circular of June 2023,<sup>31</sup> which instead of addressing the issue, further amplified the complicated position. In clause 4.3 of the circular, it said - "*resignation does not absolve the auditor of*

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<sup>27</sup> The Companies Act 2013, s 140(5).

<sup>28</sup> *Deloitte Haskins and Sells LLP v. Union of India*, (2019) SCC Online Bom 8060 (BHC).

<sup>29</sup> Prachi Bharadwaj, 'Section 140(5) of the Companies Act constitutional; Proceedings do not come to an end on resignation/ removal of an auditor' (*SCC Times*, 6 May 2023) <<https://www.scconline.com/blog/post/2023/05/06/supreme-court-upholds-constitutionality-of-section-1405-of-the-companies-act-fraud-by-auditors/>> accessed 18 January 2025.

<sup>30</sup> *Union of India v. Deloitte Haskins and Sells LLP*, (2023) SCC Online SC 557.

<sup>31</sup> 'Circular on Statutory Auditors' Responsibilities in relation to Fraud in a Company' (*National Financial Reporting Authority*, 26 June 2023) <<https://cdnbbsr.s3.waas.gov.in/s3e2ad76f2326fbc6b56a45a56c59fafdb/uploads/2023/06/2023062673.pdf>> accessed 13 January 2025.

*his responsibility to report suspected fraud or fraud as mandated by law.*” The circular, while citing the *Deloitte judgement*, misinterpreted it and failed to differentiate between cases where resignation is linked to existing proceedings under Section 140(5) and those where resignation occurs in the ordinary course of business. This development has left auditors in an ambiguous position, with unclear boundaries on their obligations once their professional engagement with a company has ended.

***A. Reducing the evidentiary value of the auditor report: An addition to the already puzzled state***

The Supreme Court’s ruling in the case of *Devas-Antrix*<sup>32</sup> becomes relevant here, where on one hand the courts attempted to increase the threshold of duty of care to be followed by auditors, this judgment took a widely different stance while examining the evidentiary value of the auditors’ report. In this case, allegations of fraud and corruption were involved. The SC held that “*the auditor’s report can neither be taken as a gospel truth nor act as estoppel against the company.*” With this reasoning, the court stated that the auditors cannot be expected to point out irregularities in agreements as they are *not technical experts* and cannot be expected to point out irregularities in agreements in which they do not hold the expertise,<sup>33</sup> and therefore cannot be solely relied upon to implicate a person.

The implications of this case extend beyond the courtroom, as attaching such minor significance to the Audit reports does not fit with the heightened expectations that the shareholders idealise. Moreover, the court’s stand was tainted by itself when on one hand, the court seems to be taking a soft stance on the auditors as seen in the *Devas Judgment*, while on the other hand,

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<sup>32</sup> *Devas Multimedia (P) Ltd v. Antrix Corpn Ltd*, (2023) 1 SCC 216 (SC).

<sup>33</sup> *ibid.*

through their judicial pronouncements along with the circular from the regulatory authority they are pushing to increase the duty of care by holding them liable for even basic negligence.

This lack of nuance has created a grey area, and such ambiguity can lead to far-reaching implications and circulars by such a reputed authority like NFRA hold significant legal standing and the language being ambiguous in any aspect can pose a great risk on the auditors, where they might find themselves in a position where they would not fully understand what is the duty of care which they need to exercise, and under which situations they are expected to exhibit increased diligence and under what circumstances their actions can be dealt by court with a soft stance.

## **VII. DELINEATING THE CONUNDRUM: UNRAVELLING THE MULTI-FACETED IMPACTS**

The complicated trajectory puts the auditor as well as the auditing firm on a pedestal, expecting them to act in an appropriate manner all the time, but this appropriate manner is itself blurred because of the tangled judicial and regulatory interpretations of the statutory duties. The said position brings multifaceted impacts.

### ***A. Impact on Professional Practice***

The current complexities in the financial world have transformed the day-to-day operations of the audit firms, for instance, over-documentation. The firms are devoting excessive time and resources to create extensive paper trails to defend against future allegations.<sup>34</sup> This defensive approach is proving to be counter-productive in the sense that this has resulted in inefficiencies while

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<sup>34</sup> Gunjan Hariramani & Pooja Arora, 'Upholding Auditor's Liability in Strict Corporate Governance: Deloitte's Case Analysis' (CBCL, 3 August 2023) <<https://cbcl.nliu.ac.in/company-law/upholding-auditors-liability-in-strict-corporate-governance-deloittes-case-analysis/>> accessed 16 January 2025.

auditing, triggering an increased risk of resignations, as notably witnessed in the *Cafe Coffee Day case*,<sup>35</sup> where the auditor's exit preceded the discovery of significant financial irregularities.

Financial repercussions arising out of the current complexities are equally manifold, these audit firms are also apprehensive as they realise the high risk associated with each new association they form with the clients, this results in cost-escalation, which in turn, affects the clients specially the small enterprises which may struggle to afford quality audit services. This ambiguity in the interpretation by the courts also leads to a sometimes excessively conservative approach while reading the financial statements, which also increases the time and growth opportunities.<sup>36</sup>

### ***B. Market and Economic Implications***

The existing state of dilemma might have far-reaching economic implications, as investor confidence in audit reports will be significantly eroded, given their ambiguous evidentiary status post the *Devas-Antrix judgment*.<sup>37</sup> This may result in investors getting more cautious, and including additional risk premiums to factor in the cost, while others might not be incentivised to invest in highly volatile businesses.

Furthermore, given the implications of the *Deloitte judgment*,<sup>38</sup> with the increased duty of care and that the auditors can be held liable post resignation, the international audit firms might be disincentivised to engage in sectors with high risk, where the need for quality audit services is the most, which will

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<sup>35</sup> 'Coffee Day Auditor resigns citing technical issues' (*Business Today*, 6 August 2020) <<https://www.businesstoday.in/latest/corporate/story/coffee-day-auditor-reigns-citing-technical-issues-269349-2020-08-06>> accessed 12 January 2025.

<sup>36</sup> Mark Defond & Jieying Zhang, 'A review of archival auditing research' (2014) 58(2) JAE 275.

<sup>37</sup> *Devas Multimedia (P) Ltd v. Antrix Corpn Ltd* (n 32).

<sup>38</sup> *Union of India v. Deloitte Haskins and Sells LLP* (n 30).

further complicate the existing state of affairs and will have far reaching implications for the market and the economy.

### ***C. Regulatory and Enforcement Challenges***

The NFRA's circular, intended to strengthen oversight, in turn, amplified the enforcement challenges. Regulators find it difficult to investigate audit failures that have now become significantly complicated, and at the same time, employ reasonable audit procedures in various commercial scenarios.<sup>39</sup> Identifying direct links between the negligence of the auditor and corporate misconduct is a significant challenge.

This regulatory puzzle is further enhanced by the issue of framing the auditors after their resignation. The challenge lies in navigating limited access to records, time gaps that blur the event timelines and discovering what the auditor would have reasonably known during their tenure.<sup>40</sup> The *Devas judgment* has added more layers of complexity by introducing the angle of auditors' technical limitations – this, in turn, creates a situation where holding auditors accountable post-resignation would become practically challenging, despite regulatory efforts aimed at extending the liability post-resignation.

### ***D. Auditors are caught in a web of ambiguity***

Due to the current dilemma, the auditors are stuck in a crossfire due to the increasingly ambiguous auditing standards as well as increased professional expectations. The Supreme Court, in cases like *Deloitte*, sets such a high standard for auditor liability with the expectation of near-perfection in the

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<sup>39</sup> Klaus Ruhnke & Martin Schmidt, 'The Audit Expectation Gap: Existence, Causes, and the Impact of Changes' (2014) 44(5) ABRJ 572.

<sup>40</sup> Mannu Arora, 'Big Four fear reputational risk as auditors resigned 10 times citing 'unsatisfactory responses' (*Economic Times*, 22 July 2020) <<https://cfo.economictimes.indiatimes.com/news/big-four-fear-reputational-risk-as-auditors-resigned-on-10-times-citing-unsatisfactory-responses/77076648>> accessed 14 January 2025.

auditing standards.<sup>41</sup> Meanwhile, in the *Devas* case, the court undermines the evidentiary value of audit reports, leaving auditors with little clarity as to how much weight and significance are attached to their work in legal proceedings. This divergence has resulted in an ambiguous environment as to what threshold of professional conduct and duties they shall subscribe to.

### VIII. GLOBAL COMPARATIVE ANALYSIS

Traditionally, India has focused on a by-the-book implementation of the auditor liability standards, though it is evolving to keep pace with the ever-changing professional ethics and complex scenarios. Globally, the approaches in this sphere have been contrasting, and India can further benefit from the best practices employed around the world.

#### *A. Position in the United Kingdom*

Principles such as *ex turpi causa* defence and attributing to the company's controlling mind<sup>42</sup> its wrongdoings govern the threshold around auditor liability. In *Stone & Rolls Ltd. v. Moore Stephens*<sup>43</sup> this threshold was discussed, and it was held that the auditors would not be liable if the fraudulent acts of a director are attributed to the company itself.<sup>44</sup> The company's ability to sue its auditors for negligence was barred as it was believed that they were involved in the fraud, with the *ex turpi causa* principle, which prevents recovery for losses arising from illegal or fraudulent conduct attributed to the auditor. This judgment opens a narrow avenue for implicating the auditors, focusing on the necessity of proving a clear breach of duty without implicating the company in the wrongdoing.

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<sup>41</sup> Klaus Ruhnke (n 39).

<sup>42</sup> Dr. Adolfo Paolini, 'Auditors' Liability and Corporate Fraud in the UK: Does Corporate Size and Structure Matter?' (2015) 10(2) JBTL 245.

<sup>43</sup> *Stone & Rolls Ltd v. Moore Stephens*, (2009) 1 AC 1391.

<sup>44</sup> Dr. Adolfo Paolini (n 42).



### ***B. Position in the United States***

The United States has recently expanded the threshold of liability attributed to an auditor who was earlier held liable for violations under a ‘recklessness standard’.<sup>45</sup> The rules were amended in August 2024 to lower the threshold of negligence. Through this amendment, now auditors can be held liable for the absence of due care, even if there is no intentional wrongdoing. The intent behind this is to promote investor confidence and increase the accountability of auditors by making sure they adhere to their responsibilities.

### ***C. Position in Australia***

Australia currently exposes its auditors to an “*unlimited liability*” for professional misconduct. CPA Australia (“CPAA”) and the Institute of Chartered Accountants in Australia (“ICAA”) have advocated for change in this approach since the middle of the 1980s.<sup>46</sup> This unlimited or infinite liability cages the auditors and prevents them from diving deep into the investigative measures and evaluating the internal records, which results in holding them back, avoiding risks and working on the bare minimum to escape any liability.<sup>47</sup>

When we compare India with other jurisdictions, we find India focusing more on adhering to the statutory standards laid down, where the violation of these standards results in both civil and criminal penalties, rather than focusing on defence principles or unlimited liability. Here, the civil liability is attached when the auditor fails to exercise reasonable skill and care, which results in

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<sup>45</sup> Mark Maurer, ‘PCAOB expands liability for auditors involved in firm violations’ (*The Wall Street Journal*, 12 June 2024) <<https://www.wsj.com/articles/pcaob-expands-liability-for-auditors-involved-in-firm-violations-23e36ed7>> accessed 15 January 2025.

<sup>46</sup> Australian Government Treasury, *Proposals for Reform: Corporate Disclosure* (Corporate Law Economic Reform Program Paper No. 9, 2022).

<sup>47</sup> *ibid.*

financial damages to the business. Under the Act and the Indian Penal Code, auditors may be held criminally liable for making false representations in reports, falsifying books, and other offences. The primary expectation here is to comply with specific ethical guidelines, and they are held liable for misconduct in their professional duties, including gross negligence.

## **IX. SUGGESTIVE FRAMEWORK ON THE LIABILITIES OF AUDITORS**

Moving forward, for India to achieve the ideal balance, it shall analyse the global standards as well as our local dynamics to gain a clearer understanding of the legislative necessity. In furtherance of the same, the following recommendations are outlined.

### ***A. Clarification of Auditor's Liability Post-Resignation: A Framework for the NFRA Circular and the Deloitte Judgment***

The Deloitte judgment, which held that an auditor's resignation does not terminate the proceedings if an application under Section 140(5) has been filed, and the NFRA Circular, which maintains that resignation does not absolve the auditor of responsibility to report fraud, have created significant confusion about the auditor's liability after resignation. Currently, the law's position remains unclear, leaving auditors uncertain about their responsibilities once they have resigned. To resolve this, authorities must provide a clear and definitive clarification through a legislative amendment or regulatory clarification establishing that an auditor's duty to report fraud is confined to fraud detected during their tenure and post-resignation liability applies only to cases under Section 140(5).

***B. Establishment of a clear standard for Gross Negligence on auditors' liability***

The inconsistency in judicial interpretations of “gross negligence” has created ambiguity in determining an auditor’s liability. While some judgments have stated that the presence of an intention to deceive is a critical factor, others assert that gross negligence can be established even without such intent, as long as the statutory duties are carried out negligently. This lack of clarity leaves auditors vulnerable to a wide range of liability claims. To address this issue, there is a need for the introduction of a clear and standardised framework, either through judicial precedent or regulatory guidelines, to define what constitutes “gross negligence” for auditors. This framework should include specific examples of negligent behaviour that would qualify as gross negligence and set forth the duty of care that auditors are expected to follow.

***C. Clarification of ‘management services’ under Section 144 of the Act***

The ambiguous interpretation of what constitutes “management services” under Section 144 by key regulators such as the NFRA and ICAI has created significant ambiguity regarding the scope of services auditors can provide. This lack of clarity hampers the uniform application of Section 144 and increases the risk of inconsistency in regulatory enforcement. To resolve this, regulatory intervention is required to provide an explicit definition of what services qualify as “management services.” The definition should be precise and comprehensive, ensuring that auditors and audit firms clearly understand what services are permissible and which are prohibited under Section 144.

## **X. CONCLUSION**

The Court's recent rulings, along with the NFRA circular, have marked a departure from the previously established stance, causing a wave of

uncertainty among the auditors. To facilitate a conducive landscape, it is recommended that the Supreme Court and the regulatory authorities examine the effect of recent judgments along with the circular and provide clarity. Allowing the current legal stance to persist would result in a state of uncertainty and confusion among the auditors about the standard of duty of care which they are expected to exercise while performing their duties. Consequently, this may create a situation where auditors would not know when they could be penalised. This, in turn, might discourage those pursuing to enter the profession.

In a rapidly evolving financial landscape, there arises a necessity for striking a delicate balance between accountability and practicality. Tackling these challenges and gathering insights from various jurisdictions, India can build a system where auditors play a proactive, trustworthy role. Employing such a suggestive framework as advised above can help us in clearing out the confusion. With the introduction of guidelines for standardisation in the approach dealing with auditor's professional misconduct while discharging the duties, there shall be an analysis of the detailed elements of gross negligence which sets a pedestal for the auditors to not cross mindlessly, which will ensure maintenance of the credibility of the auditors while upholding the ethical and professional standards of the auditing profession.