Indian Journal of Law and Legal Research **Volume VII Issue IV | ISSN: 2582-8878**

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PROFESSIONAL NEGLIGENCE AND LEGAL LIABILITIES OF AUDITORS

Sakshi Shah, LL.B. Student at Jitendra Chauhan College of Law, University of Mumbai.

ABSTRACT

Auditors are the cornerstone in shaping the trust that the users have on the financial statements. Audit is generally beneficial to the shareholders, government, lenders, or creditors, who are the end users of the financial statement. Considering this the auditor should keep in mind that it is their duty to adhere to the set standards of auditing and accounting. Key regulatory authorities and statutes governing the statutory framework of auditors in India generally includes the Institute of Chartered Accountants of India (ICAI), the Securities and Exchange Board of India (SEBI), and the Companies Act, 2013. With these professional responsibilities come inherent liabilities, which are mainly categorized into civil and criminal liability.

This paper examines auditor liability in context of professional negligence, or any professional misconduct that demonstrates incompetence in discharge of the duties by an auditor. It further considers, if the auditors have any liability towards the third parties. A comparative analysis highlights the differences in statutory framework, sources of liability, and the extent of auditor's accountability across various jurisdiction like India, UK, and USA. The study concludes that an auditor must uphold independence, professional competence, and ethical standards while exercising due care and complying with the regulatory framework, thereby it may minimize the legal risks and maintain the users trust in financial reporting.

Keywords: Auditor liability, Professional negligence, Civil and criminal liability, Financial reporting.

[1] Re Kingston Cotton Mills Co., (1896) 2 Ch. 279 (U.K.).
[2] CFI Team, Accounting Scandals – List of Top 10 Scandals in Past Decades, Corporate Finance Institute (Sept. 27, 2025), https://corporatefinanceinstitute.com/resources/accounting/top-accounting-scandals/.
[3] ICAI v. Mukesh Gang, [2016] Indlaw HYD 585 (India).

INTRODUCTION

Auditing plays an important role in understanding today's complex business environment. An auditor is the one who is responsible for examination of financial statements with a view of expressing an opinion thereon. Auditor is "a watch dog not a bloodhound," was formulated by Justice Lopes in Re Kingston Mills. [1] The auditors are required to be independent, have professional competence and integrity while adhering to their responsibilities. They should follow the required standards of auditing along with professional skepticism while auditing.

Concerns regarding legal liability of auditors tends to grow every day with passing time and auditors can also face criminal liabilities in the performance of their duties. Many fraud cases [2] worldwide would have gone unnoticed and remained undiscovered if not for competent auditors. Negligence by auditors raises significant questions regarding their legal liability and the law often holds auditors accountable when their failure to exercise reasonable care leads to financial loss or corporate misconduct. In many cases the auditors owe duties not only to their clients but also, in some instances, to third parties who rely on their reports.

A key debate in auditor liability is determining whether negligence on part of auditor amounts to professional misconduct or unethical professional behaviour required under the law. In the case of ICAI vs Mukesh Gang, [3] the Hyderabad High Court held that even a professional lapse without mens rea could constitute gross negligence.

This research paper seeks to examine the potential legal liability of auditors and their responsibilities. It explores how an auditor's negligence in performing its duties can hold them accountable under the law. The paper delves into the statutory framework, sources of legal liability, auditor's liability to third parties and provide a comparative study on audit quality followed in India, UK & USA.

[1] Re Kingston Cotton Mills Co., (1896) 2 Ch. 279 (U.K.).
[2] CFI Team, Accounting Scandals – List of Top 10 Scandals in Past Decades, Corporate Finance Institute (Sept. 27, 2025), https://corporatefinanceinstitute.com/resources/accounting/top-accounting-scandals/.
[3] ICAI v. Mukesh Gang, [2016] Indlaw HYD 585 (India).

STATUTORY FRAMEWORK

Under the Companies Act, 2013, as well as the common law principles including contract law and tort law, auditors may be held liable for negligence. In addition, auditor liability is also regulated under the Chartered Accountants Act, 1949, which establishes the Institute of Chartered Accountants of India (ICAI) that sets standards and a code of ethics for auditors. Further, the Securities and Exchange Board of India (SEBI) can also restrain auditors from practicing to some extent. Under section 147 of the Companies Act, 2013, the liabilities of the auditor are classified as below:

1. Civil liability:

Civil liabilities against the auditor may either arise in case of auditor's negligence, misfeasance proceeding for breach of trust or duty, or contract causes harm or loss to the company, its shareholders, creditors, or any other party. [4] Here the auditors may be liable for compensation or damages. In case of Irish Woolen Co. Limited v. Tyson and others, [5] it was held that an auditor is liable for any damages sustained by a company. If in any instance of misrepresentation of accounts which could have been discovered through the exercise of reasonable care and skill during the audit, but was not discovered by the auditor. This leads to question the failure of duty or incompetence on part of the auditor in performing the audit of financial statements and entails that auditor should exercise due care and skill while auditing accounts and if not will be held liable under the law.

2. Criminal liability:

Criminal liabilities occur when an auditor commits a crime under the Companies Act 2013 or any other related law, wherein these offenses can result in imprisonment, fines, or both. It may arise in case of non-compliance, [6] failure to report a fraud, False Representation, Fraudulent Activities or fraud committed by auditor himself.

[4] Divyesh Gamit, How to Avoid Legal Liabilities as an Auditor under the Companies Act 2013, Suvit (Feb. 7, 2024), https://www.suvit.io/post/liabilities-of-auditor-under-companies-act-2013 (last visited Sept. 28, 2025).
[5] Irish Woollen Co. Ltd. v. Tyson & Others, (1900) Act L.R. 23 (Ir.).
[6] M.S. Deepika Prakash, Auditors, Their Duties and Liabilities, in Corporate Law (Inflibnet e-books), https://ebooks.inflibnet.ac.in/lawp06/chapter/auditors-their-duties-and-liabilities/ (last visited Sept. 29, 2025).

In Dambell Banking Co. Ltd. (1900), [7] the directors and auditors were prosecuted under section 221 of the Criminal Code, 1872, corresponding to section 143 of the Companies Act, 2013, for issuing false balance sheets with intent to defraud shareholders. Although the auditors had admitted in letters to the managers that overdrafts were bad, they certified them as good in the accounts. The jury found all defendants guilty and sentenced them to imprisonment.

AUDITOR'S LIABILITY TOWARDS THIRD PARTY

Auditors are liable to the third parties in few instances. Firstly, if they are known users of the financial statements like shareholders and creditors of the company. Secondly, in case if a limited class of foreseeable users rely on the audited financial statements. Lastly, if the auditor signed the statement which they knew was untrue in fact. [8]

In one of the case, Commissioner of Income Tax vs. G.M. Dandekar [9] which entails the auditor's liability to third party. The Madras High Court held that an auditor was under the obligation to perform auditing with due diligence and professional skills but he is not obligated to independently investigate the truth of the assesse account. Therefore, it would be difficult to see what further obligations Mr. Dandekar had in the matter and in favour of whom. The accountant is the one responsible for preparation and presentation of correct accounts. Henceforth, the liability of auditor towards third party was established. The word Due diligence used in this instant case refers to the exercise of a level of prudence that can be reasonably expected of a person in the relevant circumstances. [10]

In one of the other leading case of, JEB Fasteners Ltd v Marks Bloom & Co (1981), [11] Justice Woolf held that auditors owed a duty of care to potential investors as a source of reliance on audited accounts which was reasonably foreseeable. However, the auditors were not held liable since the alleged negligence was not the cause of the plaintiff's loss, as the takeover would have occurred regardless, in order to secure the

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[7] The Institute of Chartered Accountants of India, Chapter 14 – Liabilities of Auditor (VCC-3rd Batch, Sept. 1, 2021), https://live.icai.org/bos/vcc-3rd-batch/pdf/Ch_14___Liabilities_of_Auditor.pdf (last visited Sept. 29, 2025).

[8] Vinamra Agrawal, Liability of Auditors to Third Party in India, Scribd (undated), https://www.scribd.com/document/364956982/Liability-of-Auditors-to-third-party-in-India-docx (last visited Sept. 29, 2025).

[9] Commissioner of Income Tax v. G.M. Dandekar, AIR 1953 Mad. 152 (India).

[10] Consolidated Eng'g Enters. v. Principal Sec'y, (2008) 7 S.C.C. 169, ¶ 31 (India).

[11] JEB Fasteners Ltd. v. Marks Bloom & Co., [1981] 3 All E.R. 289 (U.K.).

director's services. The Court of Appeal upheld this view, it also emphasized the lack of causal connection between the negligence and the loss. Therefore, even when the case recognized the possibility of auditor liability to third parties, it left the precise extent of such liability unresolved.

PROFESSIONAL NEGLIGENCE

In the auditing context, professional negligence arises when an auditor fails to exercise their duty or professional skills required in adhering to the required professional standards. While negligence generally refers to the breach of a general duty of care, whereas professional negligence is concerned with breach of specialized duties that falls under auditor's professional responsibilities. As the users of the financial statements rely on the auditor to audit the statements adequately, it is essential for them to be competent in their duties. In Caparo industries vs. Dickman case, [12] it was held that auditors owe a duty of care only to the company and its shareholders collectively, but not to any individual investors. Therefore, this ruling nullifies Caparo's negligence claim and in return the auditor were not held liable for all parties. The judgement further clarifies that limiting the scope of auditor liability to situations involving proximity of relationship and assumption of responsibility.

The law places auditors under five fundamental principles which are integrity, objectivity, professional behaviour, professional competence and due care, and confidentiality. [13] Professional negligence generally consists of three elements like- existence of duty or responsibility, occurrence of a breach of such duty, and loss suffered by the party to whom duty was owed. Auditors owe a statutory duty of care to the company they audit, and also in certain cases to its shareholders and creditors. As per the Companies Act, 2013, it is essential to report whether financial statements give a true and fair view of the company's affairs. [14] Professional negligence represents a significant ground for potential litigation against auditors if they fail to comply with set standards.

[12] Caparo Industries plc v. Dickman, [1990] 2 A.C. 605 (H.L.) (appeal taken from Eng.).
[13] Institute of Chartered Accountants in England & Wales, The Fundamental Principles, ICAEW (2025), https://www.icaew.com/technical/trust-and-ethics/ethics/code-of-ethics/the-fundamental-principles (last visited Oct. 2, 2025).
[14] Companies Act, 2013, No. 18, § 143 (India).

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COMPARATIVE STUDY OF AUDITOR'S LIABILITY IN INDIA, USA, AND UK

BASIS FOR COMPARISON	INDIA	USA	UK
Sources of liability	Auditors owes due to Client due to breach of contract, to financial users for negligence [15] and to the government for fraudulent reporting.	Auditor owes duty to client under privity of contract, liability to the users depends on state law, and to the government liability due to fraudulent or misleading auditing under Sarbanes- Oxley Act 2002. [16]	Liability to client for breach of contract, [17] restricted liability to third parties and to government due to criminal and regulatory liability for fraud.
Statutory Framework	Governed under the Companies Act 2013, [18] Chartered accountant act 1949, and SEBI regulations.	Governed under Sarbanes- Oxley Act 2002, and the Public Company Accounting Oversight Board (PCAOB). [19]	Regulated by the Financial Reporting Council under Companies Act 2006, [20] and International Standards on Auditing (UK).

[15] Corporate Finance Institute, Legal Liability of Auditors, Corporate Finance Institute, https://corporatefinanceinstitute.com/resources/accounting/legal-liability-of-auditors/ (last visited Oct. 2, 2025).
[16] Sarbanes-Oxley Act of 2002, Pub. L. No. 107–204, 116 Stat. 745 (2002).
[17] Companies Act 2006, c. 46 (U.K.).
[18] Companies Act, No. 18 of 2013, Acts of Parliament, 2013 (India), §§ 143, 147.
[19] Public Company Accounting Oversight Board, Auditing Standards, https://pcaobus.org/oversight/standards/auditing-standards (last visited Oct. 2, 2025).
[20] Financial Reporting Council, Audit, Assurance and Ethics, https://www.frc.org.uk/library/standards-codes-policy/audit-assurance-and-ethics/ (last visited Oct. 2, 2025).

Types of auditor liability	Civil liability, Criminal liability, Professional liability and Contractual liabilities. [21]	Civil liability, and Criminal liability.	Civil liability to clients, Civil liability to third parties, and criminal liability for statutory offences or fraud. [22]

CONCLUSION

Auditors play a fundamental role in maintaining integrity and reliability that users have on the properly audited financial statements. It is essential to remember that auditors provide reasonable assurance, not complete assurance on the audited statements. This research paper delves into the consequences that the auditor faces due to professional negligence. This can result in significant legal liabilities, including civil, criminal, and professional liability in India. Auditor's duty extends not only to their clients but also to third parties in some instances. Professional negligence in auditing arises when an auditor fails to exercise their duty or professional skills required in adhering to the required standards, which can potentially cause financial loss or undermine stakeholder trust. Comparative analysis highlights differences in statutory frameworks, professional standards, sources of auditor liability, and types of liability of an auditor across various jurisdictions, such as India, UK, and USA.

In conclusion, if the auditors want to avoid legal liabilities as an auditor they should stay informed about the provisions under the Companies Act 2013, follow accounting and auditing Standards, maintain independence, have integrity and objectivity, report diligently on any material misstatements found whether due to fraud or error, perform their duties with due care and competence, and maintain professional behaviour. Hence, by doing so the auditors can uphold professional and ethical standards to ensure independence and transparency in financial reporting.

[21] CA Exams, Liabilities of an Auditor, Corporate Law and Responsibilities, https://caexams.in/exams/auditors-liabilities (last visited Oct. 2, 2025).

[22] Ass'n of Chartered Certified Accountants (ACCA), Auditor Liability, https://www.accaglobal.com/gb/en/student/exam-support-resources/professional-exams-study-resources/p7/technical-articles/auditor-liability.html (last visited Oct. 2, 2025).