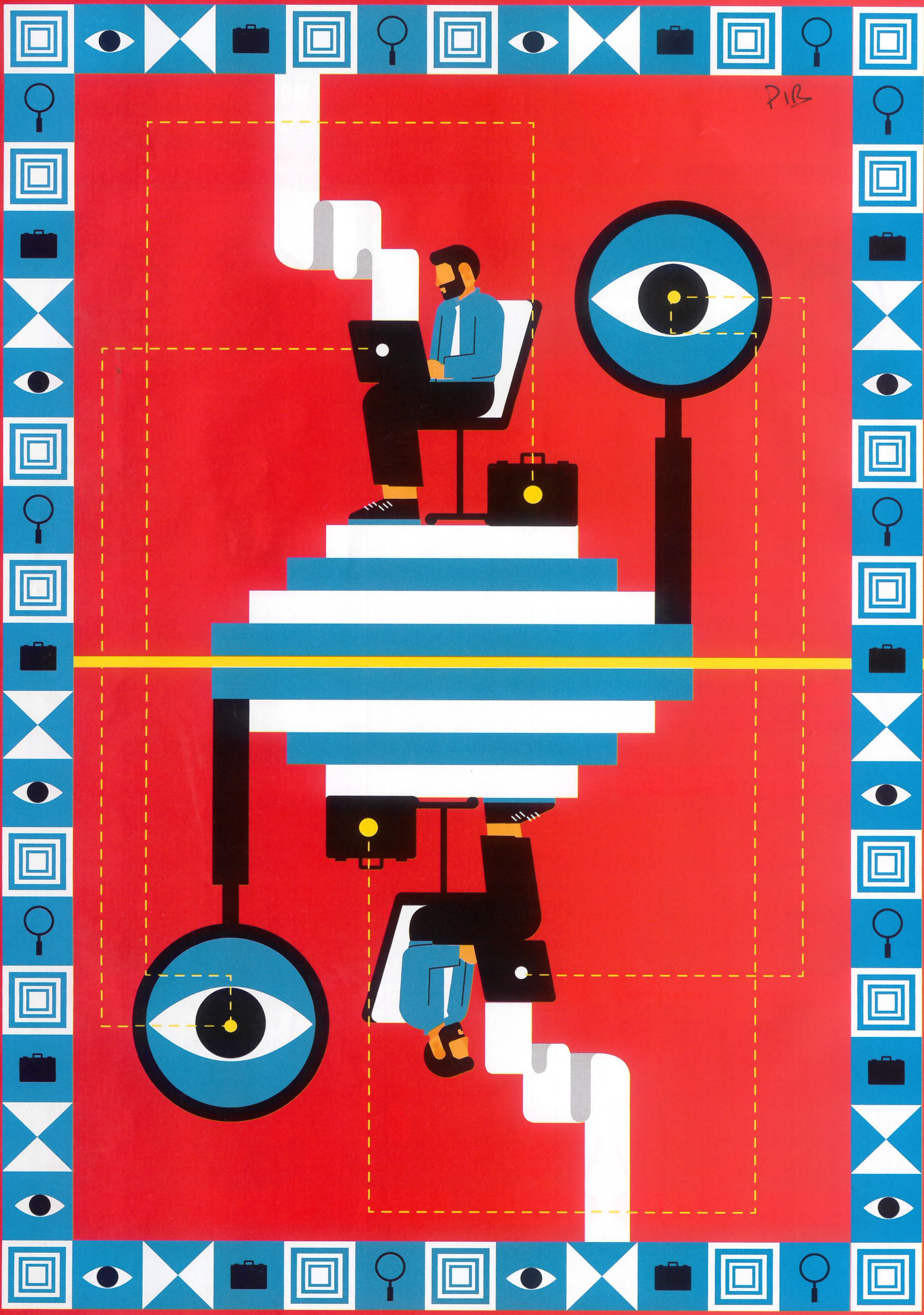
AUDITING THE AUDITORS

Are auditors the only ones responsible for reporting corporate fraud? While regulators expect them to take a more active role and more measures are in the offing, where does the buck stop?

BY SURABHI AND BINU PAUL

ILLUSTRATIONS BY **RAJ VERMA**



PIB

WHO IS RESPONSIBLE?

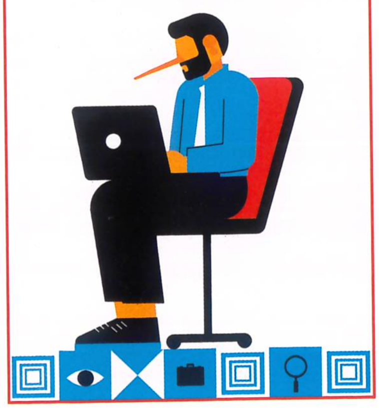
1 Statutory auditors are in a quandary amidst tighter scrutiny from regulators and the large number of problems in Indian companies

2 The National Financial Reporting Authority (NFRA) has said that mere resignation does not absolve the auditor of its responsibility to report suspected fraud

3 But experts say the board and the management also have a role to play in preventing and detecting frauds within the organisation

4 With expectations of better audit quality from auditors, their challenges would also increase

5 Overhaul of regulations for auditors is expected in amendments to the Companies Act



"The auditors fluttered anxiously. And, as always happens in their species, when something goes radically wrong and needs fixing instantly, they settled down to try to work out who was to blame."

These lines from Terry Pratchett's *Hogfather*, published 27 years ago, may well capture some of the tumult witnessed in India's auditing profession in recent times. Except it is a double blame game these days, with audited firms hitting back at accountants exiting their mandates.

Statutory auditors, responsible for certifying a company's financial health, usually carry out their work, including asking inconvenient questions to corporate managements, with a high level of discretion. But the gloves seem to be off now, as they strive to avoid regulatory strictures of the kind the erstwhile auditors of the imploded infrastructure lender IL&FS have been hit with.

Consider these developments: In June, Deloitte, the auditor of Byju's, resigned noting that there was a "significant impact" on its ability to perform the audit according to necessary standards and that it has "not received any communication on the resolution of the audit report modifications" for 2021-22.

Then in August, One97 Communications, fintech giant Paytm's parent, informed stock exchanges that Price Waterhouse Chartered Accountants had resigned as the statutory auditor of its subsidiary Paytm Payments Services due to a change in the auditor of the holding company. Price Waterhouse Chartered Accountants has "not raised any concern or issue", it asserted.

Around the same time, Adani Ports and SEZ informed the bourses that Deloitte, its statutory auditor since 2017 that was re-appointed in 2022, had resigned. Deloitte is understood to have raised concerns over certain transactions highlighted in the Hindenburg Research report about the group, and its lack of a wider audit remit relating to other listed group companies. The Adani Group firm said its board's audit committee was of the view that the grounds advanced by Deloitte for resigning were "not convincing or sufficient to warrant such a move".

The fallout between the auditors and the auditees was not restricted to initial statements, and in the first and the third cases, played out over the next few days.

In any case, there's not much love lost between the two. By the very nature of their jobs, there's a certain distance between the auditors and their clients. With a string of high-profile cases of financial irregularities in India—from the Satyam saga that began in 2008 to recent ones like IL&FS and Dewan Housing Finance Corporation Ltd (DHFL) in 2018—that raised questions about auditors, regulatory agencies often have reservations about how they discharge their role and responsibilities.

A Supreme Court decision in May this year to allow the Serious Fraud Investigation Office to resume criminal proceedings against BSR & Associates LLP and Deloitte Haskins & Sells LLP—the former auditors of IL&FS Financial Services—for their role in financial irregularities has made auditors even more cautious.

That's not all. The regulatory focus on auditors has sharpened in recent years with the setting up of the National Financial Reporting Authority (NFRA) in 2018. Its recent orders and circulars also highlight that it is keeping a close tab on auditors. For instance, in October this year, it issued 18 separate orders against branch auditors of DHFL involving a total monetary penalty of ₹18 lakh and debarment ranging from six months to one year "for professional misconduct" and "audit lapses". Earlier, it had banned two auditors for alleged irregularities in the audit of IL&FS Financial Services.

The NFRA is also overseeing a landscape dominated by the Big 5 audit firms: EY, KPMG, Deloitte, Walker Chandiok & Co, and Price Waterhouse. Per primeinfobase.com, the Big 5 handled 310 assignments of the 498 Nifty500 companies as on March 31, 2023, or almost two out of every three audits. In terms of all firms whose shares were listed on NSE (main board) as on March 31, 2023, they handled 551 assignments of 1,869 companies (for which auditor details were available for 2022-23; details were not available for 13 companies), or 29.48 per cent of the total.

THE INDEPENDENCE OF AUDITORS

A key issue has always been auditors' independence. "Questions arise over this as the company pays the audit fee to the auditor so how far can they be independent," notes Ameet Patel, Partner, Manohar Chowdhary & Associates, and past president of Bombay Chartered Accountants' Society.

The Company Law Committee had recommended providing a differential list of prohibitions on non-audit services by auditors

BAD APPLES EXIST

- **Auditors have faced regulatory action in the past for various non-compliance issues**
- **But given the size of the industry, these are few and far between**

(Action against auditors/CAs for their roles in serious financial irregularities)

80
Complaints filed by SFIO against auditors with ICAI in the last five years

137
Cases (complaint/ information) in which punishment has been awarded by the disciplinary committee* (including those cases, which were referred to the disciplinary committee during the earlier years)

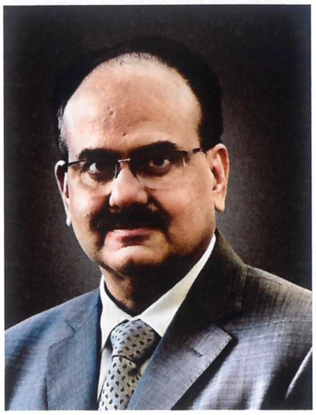
*INCLUDING COMPLAINT AND INFORMATION CASES WHERE ICAI'S DISCIPLINARY COMMITTEE AWARDED PUNISHMENTS IN 2021-22

SOURCE PARLIAMENT PAPERS, ICAI, NFRA

13
Applications against the auditors u/s 140 (5) of the Companies Act, 2013 before the NCLT for removal and debarment for five-year period in the last five years

25
Debarment orders by NFRA for periods from one to 10 years

56
Orders passed by NFRA against auditors of companies



"Financial statements that contain misstatements due to fraud or error will never reflect the true state of the companies. The auditors' role is to ensure that financial statements audited by them are free from frauds and errors"

AJAY BHUSHAN PANDEY
CHAIRMAN, NFRA

STATUTORY AUDIT: WHY AND HOW

Under the Companies Act, every company needs to appoint a statutory auditor to audit its financial accounts

A company's board must hire a statutory auditor—who should be a practising CA—at its first annual general meeting

Statutory audit provides a correct representation of the company's financials

Auditor must submit the audit report to the company and shareholders

In most companies, auditors can be appointed for a maximum term of five years

In individual companies, auditors can be appointed for one term only; and in partnership firms, for two terms only

of large public interest entities to maintain their independence. Non audit services can include any professional service that an auditor can provide to an audit client, but certain services such as accounting and book keeping are already barred. While this is still pending along with other planned amendments of the Companies Act, 2013, a number of firms such as Deloitte and Price Waterhouse have voluntarily chosen not to offer non-audit services in India. The amendments are aimed at further enhancing the independence of statutory auditors with proposals such as clarifying "management services" or non-audit services that an auditor would be prohibited from taking up for an audit client as well as a cooling off period before a former auditor can take up a board position at a company. It is also likely to provide for a joint audit for at least some firms. According to sources, the Ministry of Corporate Affairs is consulting stakeholders on this.

THE RESIGNATION ROUTE

What has made auditors more wary is an NFRA circular in June that noted that they are not discharging their mandatory obligations to report fraud and suspected fraud to the central government and the board or audit committee. "Resignation does not absolve the auditor of his responsibility to report suspected fraud or fraud as mandated by the law," it underlined.

NFRA Chairman Ajay Bhushan Pandey points out that the recent decision of the Supreme Court has highlighted this aspect and has reiterated that auditors cannot avoid reporting of fraud by taking the resignation route.

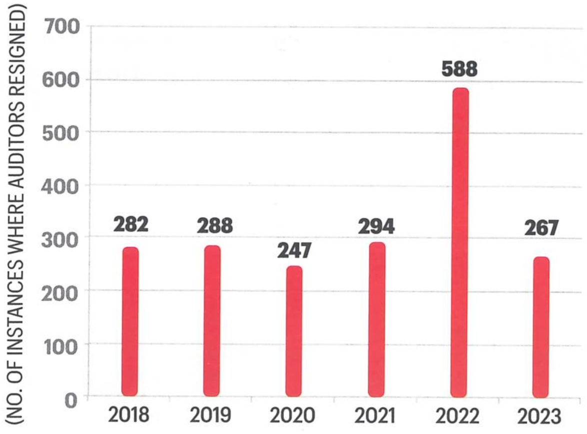
"Financial statements that contain material misstatements due to fraud or error will never reflect the true and fair view of the state of affairs of the companies. The auditors' fundamental role is to ensure that the financial statements audited by them are free from frauds and errors," he tells *BT*, adding that there was a need to reiterate these important provisions of the Standards on Accounting and the Companies Act for the attention of the audit profession, those charged with governance (TCWG), and other stakeholders.

Data from primeinfobase.com reveals that there have been 1,966 instances of resignations by auditors between January 1, 2018, and October 10, 2023, from NSE-listed companies and firms exclusively listed on the BSE with a market cap of more than ₹1,000 crore. The cessations have been for various reasons, including no intimation for further continuation, expiry of term, complying with regulatory norms, disqualification by the Reserve Bank of India, as well as mid-term cessations where no reason was provided. (*See box 'Cessation of Auditors'*)

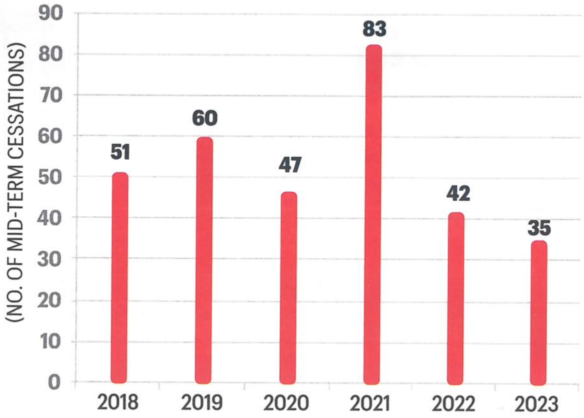
Pandey also raises the point that along with the auditors, the TCWG—the board of directors, audit committee and independent directors—are also responsible

CESSATION OF AUDITORS

Since January 1, 2018, nearly 2,000 auditors have resigned from listed companies with a market cap of over ₹1,000 crore



Auditors can resign for various reasons, like meeting statutory regulations, expiry of term, health or personal reasons, or disqualifications



NOTE: DATA FROM JANUARY 1, 2018, TO OCTOBER 10, 2023, FOR NSE-LISTED COMPANIES
SOURCE PRIMEINFOBASE.COM

under the Companies Act and markets regulator the Securities and Exchange Board of India's (Sebi) Listing Obligations and Disclosure Requirements (LODR) for ensuring the integrity of financial reporting and preventing frauds.

"That is why the law mandates a coordinated approach communication between auditors and TCWG to ensure that financial statements present a true and fair view of the firm and are free from material misstatements whether due to fraud or error," he says. While NFRA looks into the role of the auditor, Sebi and the Registrar of Companies are tasked with looking into omissions and commissions by the TCWG and others in the companies with respect to frauds or misstatements, Pandey says.

There is general consensus between auditors and investors that the buck cannot stop with the auditor and the onus also lies with the board and independent directors.

Yogesh Sharma, Deputy Managing Partner at consultancy BDO India, notes that the law has given significant powers to auditors. "They don't always have to resign. They can take up the issue with the board or stakeholders and if that is not sufficient, they can highlight the issues in the audit report. Overall, auditors have also become more careful in onboarding clients and there is no longer a rush to get as many clients as possible," he says.

Srinivasa Rao, Leader and Partner-Risk Advisory Services at CA firm Nangia & Co LLP, agrees that the auditor has various options such as issuing a modified audit opinion that clearly states the nature and extent of the disagreement and its impact on the financial statements. Alternatively, they can communicate the disagreement and its implications to the audit committee, board, shareholders as well as to relevant regulators and authorities or recommend corrective actions to the management and the audit committee.

INDIA INC.'S FINANCIAL WOES

What has made it tougher to prevent frauds, despite the plethora of measures taken by the government and regulators as well as extensive due diligence by auditors, are the problems within the companies they oversee.

"Intentionally designed fraud by people in control of the company is very difficult to detect because that's how it has been designed. But that doesn't take away the responsibility of the statutory auditor, even though they are not forensic auditors. But there is higher expectation from auditors now," says Sharma of BDO India.

In fact, of late financial problems have come to the fore in India Inc. amidst a trend of chasing high growth at all costs, somewhat accelerated by the rise of start-ups. In the past two years, a number of start-ups like BharatPe, Zilingo, Trell, GoMechanic and Mojocare have been accused of fraudulent practices and poor governance

A SNAPSHOT OF INDIA INC.

- **62 per cent of the total registered companies are active**
- **Public limited companies are smaller in number (5 per cent), but account for 64 per cent of the total paid-up capital**
- **Private limited companies account for 95 per cent of the total companies and 36 per cent of the total paid-up capital**

2,461,937 No. of companies registered in the country

1,517,008 No. of active companies

1,506,491 Limited by Shares | **296** Unlimited | **10,221** Limited by Guarantee

69,110 Public limited companies | **1,437,381** Private companies

6,739 Listed | **62,371** Unlisted

DATA AS OF JANUARY 2023
SOURCE MINISTRY OF CORPORATE AFFAIRS (MCA)

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YOGESH SHARMA
DEPUTY MANAGING PARTNER, BDO INDIA

standards. In BharatPe and Zilingo, investigations led to the sacking of founders and several employees over suspected financial irregularities. The biggest of the start-up issues is being played out at Byju's—which faces allegations of misgovernance. Three board members have stepped down from the company and its statutory auditor Deloitte Haskins has resigned. The firm has faced allegations of aggressive marketing tactics, mis-selling to parents who were financially unprepared for the offerings, and failure to file audited accounts.

"It's a combination of large business failures due to various issues and problems in start-ups that are responsible for many of the financial issues that plague India Inc. today," notes a senior auditor who declined to be identified, adding that the boards of start-ups also need to be made more accountable.

Experts and industry players say investors too need to remain vigilant. Often times, a new board or industry veterans are roped in by the government or investors—be it in the case of IL&FS or Byju's—to restore normalcy, if not to sort out the mess and regain public trust.

Entrepreneur Somdutta Singh, Founder & CEO of e-commerce solutions provider Assiduus Global Inc., says investors can stay vigilant by adopting a multi-pronged approach. This includes conducting thorough due diligence before investing, keeping a close eye on red flags such as inconsistent financial performance, excessive insider transactions, or frequent change of auditors and keeping open communication channels with the start-up's management and asking probing questions.

To combat issues in the start-up sector, the Ministry of Corporate Affairs is working on a regulatory regime for large unlisted companies—aimed at privately held start-ups, under which they would have to adhere to corporate governance norms. The Company Law Committee is understood to have been tasked with the issue.

Another challenge for almost everyone—be it the auditor or board members—is lengthy audit reports that can often run into hundreds if not thousands of pages, due to the higher regulatory requirements. "With increasing volumes of data sent to board members for their reading and analysis—often in large corporations and financial institutions, these run into several hundreds of pages for every board meeting—

and often at short notice, this raises the pertinent question of how a director can feasibly absorb such vast amounts of information and adequately prepare for their board duties," points out Srinath Sridharan, an independent commentator and corporate advisor.

EVOLVING ROLES

Most auditors also highlight that the expectations from statutory auditors have undergone a shift over the years. Patel of Manohar Chowdhary & Associates says that while earlier the auditor was seen as a watchdog, this has now changed. "The detection of fraud is not a watchdog's duty but of a bloodhound," he says, adding that in many instances, audit firms have not moved with the times and continue to maintain that detecting frauds isn't their job. "Auditors need to build capacity in data handling, audit documentation, which are becoming more important day by day," he adds.

Based on feedback, the Institute of Chartered Accountants of India (ICAI) and audit firms are taking measures to improve capacity. The ICAI introduced the Forensic Accounting and Investigation Standards (FAIS) in July 2021 and also issues guidance notes, technical bulletins, and advisories to keep its members updated on the latest developments.

In an earlier interaction with *BT*, ICAI President Aniket Talati had highlighted initiatives being taken by it such as upskilling chartered accountants and students for the digital economy and the use of artificial intelligence. The ICAI declined to answer queries from *BT* for this story. EY, PwC, KPMG and Deloitte, too, did not respond to emailed queries.

Everyone agrees that there are some bad apples. With more than 6,000 listed firms and thousands of unlisted ones, there will be some cases of wrongdoing, be it by the board or the management alone or in connivance with the auditors. And auditors reiterate that such cases are few and far between. (*See table 'Bad Apples Exist'*). But questions remain if more can be done.

The NFRA Chairman says India is seen as a bright spot among emerging markets by global investors. "We also see increased participation of Indian small and retail investors in capital markets in recent times... All of them need more trust in the financial reporting by the corporate world," he says. Audit processes will continue to evolve as new businesses and business practices emerge, with more action expected in the coming months. Amendments to the Companies Act, 2013, would bring new regulatory requirements while an appeal by NFRA in the Supreme Court to probe pre-2018 cases could also open up further discourse. All this is sure to keep auditors on their toes. BT

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SRINATH SRIDHARAN
INDEPENDENT MARKETS COMMENTATOR AND CORPORATE ADVISOR

WHAT NEXT?

- The government, the NFRA and the ICAI plan to introduce more measures for enhancing the independence of auditors, and better regulation
- Amendments to the Companies Act for statutory auditors with provisions like a cooling-off period, non-audit services
- NFRA had floated a draft Annual Transparency Report that would be submitted by auditors
- ICAI is working to upskill CAs and students on the digital economy, use of artificial intelligence
- A regulatory regime for large unlisted firms like start-ups is being planned to improve their corporate governance