

The Credibility Crisis

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The said company along with its group performed round tripping of loans and a series of transaction to fraudulently makeover its financial statement (that's what window dressing is called). So you would be wondering that don't we have enough laws and regulations to curb this type of transaction or this type of fraudulent makeover? Well the answer is YES, WE HAVE. We can't imagine a ruling party or some government officer checking all the transactions and items of each and every company; therefore we have body set up by an act of Parliament called Institute of Chartered Accountants of India (ICAI) who have members to perform all such kinds of operations. Here the ICAI have set of standards to be followed by each and every member. Along with this standards the members have to follow all the laws and regulations applicable on their client. The revenue model is that the clients have to pay the remunerations to the members, hereinafter referred as chartered accountants or CA. In the present case the CA Firm who is entrusted with the duty to provide an assurance on financial statement in accordance with laws, regulations and standards had failed in his duty to do so. So, before getting into facts of the scam let us understand the LAWS, REGULATIONS AND STANDARDS governing this matter.

Legal Provisions

As per companies act 2013 -

1. Sec 140(5) states that "Without prejudice to any action under the provisions of this Act or any other law for the time being in force, the Tribunal either *suo motu* or on an application made to it by the Central Government or by any person concerned, if it is satisfied that the auditor of company has, whether directly or indirectly, acted in a fraudulent manner or abetted or colluded in any fraud by, or

ABSTRACT

The IL&FS crisis has given birth to a new crisis in Indian Economy – 'The Credibility Crisis'. The Big four audit firms dominates with the market capitalisation companies audited by them being 67% of the total market capitalisation of all the companies listed at National Stock Exchange during 2018-2019. So this concentration risk had got crystallised in previous days as credibility crisis in corporate sector.

Keywords: Big 4's, IL&FS, SFIO, Concentration Risk

Introduction

The Deloitte and KPMG groups audit more than 250 companies that make up about 40% of the market capitalisation of listed companies. Now you would be wondering that why am I here with all these facts and figures? Well my answer would be that I am pointing at the "Concentration Risk". Deloitte and KPMG had performed Joint Audit for IL&FS (Infrastructure Leasing and Financial Services Limited), a company who is in crisis for committing fraud. Business Standard reported, As per the investigation report, which is part of the first chargesheet filed by the Serious Fraud Investigation Office (SFIO), IFIN and other entities from the IL&FS (Infrastructure Leasing and Financial Services) group continued to continuing to get pleasure from high ratings from numerous rating agencies because of window-dressing of the corporate books done by auditors.

in relation to, the company or its directors or officers, it may, by order, direct the company to change its auditors:

Provided that if the application is made by the Central Government and the Tribunal is satisfied that any change of the auditor is required, it shall within fifteen days of receipt of such application, make an order that he shall not function as an auditor and the Central Government may appoint another auditor in his place:

Provided further that an auditor, whether individual or firm, against whom final order has been passed by the Tribunal under this section shall not be eligible to be appointed as an auditor of any company for a period of five years from the date of passing of the order and the auditor shall also be liable for action under section 447."

2. Sec 144 states that "**Auditor not to render certain services** - An auditor appointed under this Act shall provide to the company only such other services as are approved by the Board of Directors or the audit committee, as the case may be, but which shall not include any of the following services (whether such services are rendered directly or indirectly to the company or its holding company or subsidiary company, namely:—

- A. accounting and book keeping services;
- B. internal audit;
- C. design and implementation of any financial information system;
- D. actuarial services;
- E. investment advisory services;
- F. investment banking services;
- G. rendering of outsourced financial services;
- H. management services; and
- I. any other kind of services as may be prescribed:

Provided that an auditor or audit firm who or which has been performing any non-audit services on or before the commencement of this Act shall comply with the provisions of this section before the closure of the first financial year after the date of such commencement.

Explanation

For the purposes of this sub-section, the term "directly or indirectly" shall include rendering of services by the auditor,—

1. in case of auditor being an individual, either himself or through his relative or any other person connected or associated with such individual or through any other entity, whatsoever, in which such individual has significant influence or control, or whose name or trade mark or brand is used by such individual;
2. in case of auditor being a firm, either itself or through any of its partners or through its parent, subsidiary or associate entity or through any other entity, whatsoever, in which the firm or any partner of the firm has significant influence or control, or whose name or trade mark or brand is used by the firm or any of its partners."
3. Sec 143(12) states that "Notwithstanding anything contained in this section, if an auditor of a company, in the course of the performance of his duties as auditor, has reason to believe that an offence involving fraud is being or has been committed against the company by officers or employees of the company, he shall immediately report the matter to the Central Government within such time and in such manner as may be prescribed."
4. Sec 143 (9) states that " Every auditor shall comply with the auditing standards."
5. Sec 143(10) states that " The Central Government may prescribe the standards of auditing or any addendum thereto, as recommended by the Institute of Chartered Accountants of India, constituted under section 3 of the Chartered Accountants Act, 1949, in consultation with and after examination of the recommendations made by the National Financial Reporting Authority.

Provided that until any auditing standards are notified, any standard or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards."

As per Standards on auditing (SA) issued by ICAI -

1. SA 200 dealing with "Overall objective of independent auditor and conduct of audit in accordance with SA" state that auditor should be independent and independence comprises of both independence of mind and independence of appearance.
2. SA 705 states that if financial statements are materially misstated or the auditor is unable to obtain any Sufficient and Appropriate Audit Evidence (SAAE) the auditor can issue Qualified Opinion or Adverse Opinion or can even Disclaim his Opinion.

SFIO (Serious Fraud Investigation Officer) Report Extracts

Following are some of the key points highlighted in SFIO report:

- "Audit and credit rating agencies are part of IL&FS failure crisis. There is material evidence to show they failed to apply basic test for transaction analysis. They completely overlooked the asset book and had not examined and reported properly."
- "There was lack of due diligence with respect to the loans sanctioned by IFIN. There are instances where

non-compliance are apparent and the firm turned a blind eye."

- "Deloitte has been with IL&FS and subsidiaries namely IFIN, ITNL, ISSL and many other group companies as its statutory auditor for the last ten years. Its annual average audit fee used to be Rs 13-14 crore and advisory and consultancy fee around Rs 6-8 crore per annum. The firm did not audit IL&FS books with due care and professional skepticism. The probe has revealed that the auditors have failed to perform the duties as mandated under The Companies Act."
- "The ever greening of the loans resulted in inflated profits, suppressed provisioning and non-disclosure of possible NPAs in the books of IFIN. To this extent, the financial statements were misstated to show a window-dressed view or a rosy picture of the financials."
- The said company didn't disclosed Net Owned Funds (NOF) and Capital Reserve Adequacy Ratio (CRAR) as per RBI guidelines from 2014-15 at the time availing funds from banks. The report cited that "This information is very critical and material for the banks to take decision on lending to IFIN. The management of the company concealed the material information from banks while availing of loans."
- The 800 pages charge sheet filled also accused the company and its directors of floating a Domestic Shell Company (a company which does not have any function apart from acting as a part in round tripping transaction) to route funds which was used by his own group companies to pay liabilities to IFIN.

Observations from the present case

First of all apart all these irregularities in the book the joint auditors, Delottes and KPMG failed to address in their audit report. Instead they issued a clean report which is violation SA 705. The audit report issued provided a reasonable assurance on true and fairness of financial statement. Government has contended that there are 22 places where the joint auditor had violated the SAs.

There are sufficient evidences from internal emails which shows that Delottes was involved in providing accounting and management consultancy services to IL&FS which results in violation of section 144 of companies act 2013 which states that auditor shouldn't render services related to accounting or management consultancy. By providing these type of services auditor gets into self review threat which affects its independence violating requirements of SA 200.

The said joint auditors had not mentioned anything about the fraud going in the said company which is mandatory to be stated in the audit report failing which will lead to violation of section 143(12) of companies act.

Therefore the SFIO charge sheet allegations are correct in taking action as per section 140(5) of companies act by proposing to ban the audit firms for 5 years.

Not a Conclusion But a New Outlook

National Company Law Tribunal (NCLT) had asked the company to file its response by 21st June of 2019. This action can uncover more misstatements in other group entities as these findings may be tip of the iceberg. If NCLT takes any action as per section 140(5) then it would be for the first time in our country that Big 4 would be banned for 5 years well in the other way round if nothing gets proved and the audit firm comes clean then it would be a great for our economy as the brand trust on Big 4's would be back.