

[2023] 151 taxmann.com 40 (Article)

Auditors under sterner lens - Deloitte case fall-through



RAJI NATHANI

FCMA, Advocate



GOPAL NATHANI

FCA

Background of the case

The recent Supreme Court ruling in *Union of India v. Deloitte Haskins and Sells LLP* [\[2023\] 150 taxmann.com 77 \(SC\)](#) is an outcome of the investigation initiated by the Department of Economic Affairs, Ministry of Finance who issued an Office Memorandum dated 30-9-2018 in respect of IL&FS ('IFIN') to the Ministry of Corporate Affairs, Union of India requesting it to take action under the Companies Act, 2013. The Memorandum and Note highlighted that:

- a. the IL&FS Group was struggling with a debt contagion of approx. Rs. 91,000 crores against Rs. 6,950 crores in equity share capital and reserves, leverage of at least 13 times. Moreover, in the year 2017-18, the IL&FS Group has shown a loss of Rs. 2,670 crores;
- b. this debt contagion, *prima facie*, was on account of *inter alia* failure of corporate governance across the IL&FS Group and window-dressed accounts; and
- c. any further defaults would be catastrophic for the well-being of the financial markets and the economy.

Based on this note the corporate affairs ministry forwarded the case for the further round of investigation to SFIO as well as moved a petition to NCLT for the removal of then-existing Board of Directors of IL&FS and the appointment of a new Board of Directors in place.

Upon receipt of the interim report of SFIO, immediate prosecution is initiated against auditors as well as the auditors were placed under suspension under the second proviso of section [140\(5\)](#) of the Act, 2013 thus preventing BSR, its engagement partners, Deloitte and its engagement partners from undertaking an audit for any company for a period of five years. On the basis of the interim report, the Ministry of Corporate Affairs filed a Miscellaneous Application in Company Petition No. 3638/2018 against the erstwhile Directors of the companies in the IL&FS Group seeking to implead them in the said proceedings and an order to attach their immovable/movable properties. In an order passed in section 130 petition, the NCLT

directed that the accounts of IL&FS, IFIN & ITNL for the past 5 financial years be re-opened and recast on the ground that the affairs of IL&FS, IFIN & ITNL had been mismanaged casting doubt on the reliability of the financial statements/accounts. Reserve Bank of India (RBI) also initiated an inspection of the IL&FS and IFIN under section 45N of the RBI Act, 1934.

Auditor's dilemma

In the ILFS case, the same auditor held a long innings. Deloitte was the statutory auditor of IFIN from 2008 till 2018. Deloitte retired by efflux of time in 2018 and BSR was appointed as the joint statutory auditor in 2017 so both Deloitte and BSR jointly conducted the statutory audit of IFIN for the Financial Year 2017-2018, year preceding to collapse. The auditor's role is mainly guided by their CARO report format which has broadened further consequent to the frequent changes in the economic and regulatory environment. The clauses therein almost desire them to report both breaches in accounts and financials and instances of violation of statutory duties/ compliances by those in the governance of the affairs of the company. On the reporting of any fraud instance or fraudulent conduct against or by the company or those in-charge there is often a dilemma in the mind of the auditor who often would follow a distanced and soft approach over a proactive investigating approach to suspected fraud.

With the collapse of ILFS, investigations were initiated by the central government agencies and NCLT. Both the board and auditors were shunted out after due procedures under the Companies Act, 2013.

This decision is a clear pointer that an auditor cannot wash off his hands in a fraud case. This ruling gives a direction to lay scope of every auditor to include reporting on fraud suspect transactions with a clear narrative. For instance, a banker would mean business and is more interested to know if the particular amount of instalment released by them is used for given purpose only, whether the company or its promoters follow ethical practices or not, or have strong employee culture, or ethical class of people on the board, which facts must be well understood by the auditor without any bias.

Auditor's supreme role

In one of their challenge before the Supreme Court, it is submitted that section 140(5) is violative of Article 14 of the Constitution of India and discriminates against them unfairly in comparison to similarly placed alleged perpetrators, such as directors, management etc. The Hon'ble Justice M R Shah of the Supreme Court in rejecting such plea made the following significant observations: -

" It is required to be noted that the role of auditors cannot be equated with directors and/or management. Auditors play very important role in the affairs of the company and therefore they have to act in the larger public interest and all other stakeholders including investors etc. Chapter X of the Act specifically deals with the "Audit and Auditors" looking to the importance of the auditors. Therefore, section 140(5) cannot be said to be discriminatory and/or violative of Article 14 of the Constitution of India."

(unquote)

By these observations therefore the auditors assume a far more superior role than the board of directors and independent director of the company. It is thus given that the board and the promoters are also subject to scrutiny by the auditor at any given point in time. This decision provides a strong mandate to the auditor to scrutinise those who are part of the governance team. In that sense, therefore, an auditor has the mandate to spread his wings all across to vouch for any transaction without abetting or colluding in fraud with the management of a company.

Analysis

The auditors are also obligated to comply with the Standards on Auditing ("SA") dealing with the responsibility of the auditors to obtain reasonable assurances that the financial statements are free from material misstatement, whether caused by fraud or error. On similar lines, the earlier English ruling in ***Kingston Cotton Mills, In re*** [1986] 1 Ch. 331 also highlighted that an auditor ought to be "**a watchdog and not a bloodhound**" which seems reasonable as they are only obligated to look into the matters provided by the management in the financial accounts. In the ***ICAI v. P.K. Mukherjee*** AIR 1968 SC 1104 case, the SC stated that the auditors shall perform their duty keeping in mind that they are obligated to inform the stakeholders about the company's true financial position. They are also expected to step into the shoes of a watchdog on behalf of all the stakeholders and therefore are under a "*clear duty towards the beneficiaries to probe into the transactions and to report on their true character*". The Indian judiciary has increased the accountability of the auditors by pinioning liability and responsibility on them in the light of recent corporate scandals such as WorldCom, Satyam, Café Coffee Day, IL&FS, etc. Post these frauds, the government is also advocating through the "**Companies (Auditor's Report) Order, 2020**" that specifies an extensive list of topics on which the auditor must make a statement in the Auditor's Report. Further, the MCA also released a Consultation Paper, seeking public input on the development of a '**Composite Audit Quality Index**' to improve the accountability of auditors and audit firms.

Keeping note of this enhanced role, it is therefore important that **CARO** reporting must also answer direct questions on instances of any failure of corporate governance and any instance of window dressing of accounts to bring into light suspect cases of fraud and falsification of accounts. Even the Institute of Chartered Accountants of India in their **Guidance Note on Reporting on Fraud** under Section 143(12) of the Companies Act, 2013 (Revised 2016) in the introductory paragraph has also emphasized that there is a strong nexus between prevention of fraud and good corporate governance. For instance, while being a participant in assurances practices conclave, I heard few finance personnel on the panel admitting that reimbursements such as fuel, travel and the like in their companies with 90-95% amounts are by default unverifiable and is a gray area. This according to me is a clear case of failure of corporate governance and misappropriation of assets of the company with a clear con intent that must be reported by the auditor in their cases.

These powers and obligations mentioned above clearly indicate that the auditors were not supposed to take a load off but rather be pre-emptive to deal with corporate frauds lest be held responsible if inadequacies in their audit resulted in failure to detect the fraudas ***Fraus est celare fraudem*** (It is a fraud to conceal a fraud). Apparently, they have a duty for fraud detection Inter alia, which, while not absolute, is an important obligation

..