Role of auditors, in light of Satyam scam

♣ *Harsh Gagrani & Ritika Jhurani*

INTRODUCTION

Consequent to a written confession by Satyam Computer Chairman B. Ramalinga Raju, admitting to the recent multi crore scam of misrepresenting facts in the Company's balance sheet to the tune of around Rs. 8000 Crore, has brought the role of auditors and accountants for the company under scrutiny.

The role of PricewaterhouseCoopers- the statutory auditors in "India's Enron" comes under the spotlight amid allegations that large Indian companies regularly use misleading accounting techniques and bully analysts, accountants and auditors into staying quiet.

Given the scandals of the past like Worldcom, Parmalet and Enron, the imminent issue is how effective and trustworthy Auditors really are.

An Auditor, first and foremost has to be a Chartered Accountant under the Chartered Accountants Act, 1949. He is the person appointed to examine the books of account and the accounts of a company registered under the Companies Act, and to report upon them to the company's shareholders. Audit means the examination or assessment of a company's annual accounts, i.e. a balance sheet, profit and loss account and other financial statements as required by law.

Under the Companies Act, an auditor is required to express an opinion as to whether the annual accounts give a true and fair view of the company's state of affairs and financial position. To formulate such an opinion, the auditor needs to examine the company's internal accounting system, inspect its assets, test-check of accounting transactions.[1]

♣ **Authors are the 3rd year students of National Law Institute University, Bhopal.**

[1] Ghosh, K.M & Chandratre, K.R Indian Companies Act

DUTIES OF AN AUDITOR

The statutory duties of the auditor basically entail the following:

1. Duty to make certain inquiries
2. Duty to make a report to the company on the accounts examined by him
3. Duty to make a statement in terms of the provisions prescribed.

The auditor has a duty to inquire into certain matters and seek any information required for the audit, from the company. This could be in relation to security on loans and advances made by the company, any transactions entered into by the company and whether they are prejudicial to the interests of the company, whether personal expenses are recorded and charged to proper accounts, any transaction with respect to sale of shares and whether the position depicted in the books and balance sheet is correct, honest and proper.

If there are any suspicious circumstances or unusual transactions like unavailability of original documents, or sudden increase or decrease in shareholdings or debt, employees given the liberty to access unauthorized documents etc., then the auditor is under a clear duty to "probe into these transactions" and ensure that they are proper and legal. At all times, auditor has to act with care and skill of a professional of reasonable competence. The degree of care and skill required however, varies from case to case.

Auditor's Report

Under Section 227 of the Companies Act, the auditor is supposed to report to the beneficiaries of the company i.e. the shareholders in the general meeting, about the books and accounts of the company, the balance sheet and profit and loss account on the basis of their assessment. They have to give their opinion on the financial position of the company and also make sure that it has been fairly, truly and honestly depicted.

As per Section 227 of the Companies Act, the report should also state-

1. That the auditor has obtained all information and explanations, which are to the best of his knowledge and belief necessary for his purpose;
2. Whether in his opinion, all the books of accounts and requisite documents necessary for the audit have been furnished by the company;
3. Whether the balance sheet and profit and loss account comply with the books of accounts; and
4. Any observation and comments on the functioning of the company, especially, which may have an adverse effect on the company.

He is thus required to report not merely on the balance sheet but on the accounts he examines, and he also has to express his opinion whether the company has properly kept all the books as per law and whether the balance sheet and profit and loss account are in accordance with the accounting standards and procedures prescribed by the ICAI.

The report should be complete, concise, clear and unambiguous and the auditor should be careful about the language used, as the readers of the report are all laymen.

Auditor's opinion can be qualified or unqualified. A qualified opinion is an opinion subject to certain reservations. That means that the auditor is unable to satisfy himself that the accounts present a true and fair view of the company's financial position. As per Section 227(4) of the Companies Act, the nature and reasons of qualification should also be clearly stated, instead of merely stating grounds for suspicion.

For the purpose of drawing up the report, the auditor is given the right to inspect and examine the books and accounts, balance sheets and vouchers or any other requisite documents necessary for the purpose of the audit. These documents can be accessed by the auditor at all times, irrespective of where they are kept. The auditor can also ask for any information and explanation from the officers of the company, and the officer would be under a duty to furnish the information and explanation so needed.

Duty to report fraud

During the course of the audit, the auditor could come across situations where he discovers that a senior employee is defrauding the company or using unfair practices, then an obligation arises of the auditor to report what he has discovered to the management immediately so that appropriate action can be taken. If the auditor identifies the possible existence of fraud or other irregularities in accounting practices, the auditor should attempt to clarify it or report it. There may be circumstances, where the auditor needs to report to a third party without the consent and knowledge of the management, when he suspects that the management may be involved. The auditor should consider the magnitude of loss that will occur due to the fraud and irregularity and the number of people that will be affected by it or the possibility of recurrence of the fraud if gone unreported. As a measure of recoverable loss, the court noted that no losses would have been incurred from the date of discovery if the auditor had taken some action to blow the whistle.[2]

Auditor's duties to third parties

The courts have held that if the auditors know or have reason to believe that the accounts so prepared by them will be relied upon by third parties, they are under a duty to ensure that those accounts are carefully prepared and that they don't contain any false information or negligent misstatements and that they reflect a true and fair reflection of the company's financial position.

There is no legal principle that a holding company is unable to recover damages for loss in the value of its subsidiary resulting directly from a breach of duty owed to the company itself, as distinct from a duty owed to the subsidiary.[3]

With respect to the duty of auditors towards shareholders and investors, in the case of Caparo Industries Plc. vs Dickman[4], the plaintiff company, in an attempt to make a bid for the takeover of another company, relied upon the accounts and statements prepared by the auditors of the target company and suffered a loss, due to inaccuracy of the accounts. In an action against the auditors, the court held that the auditor owed a duty to the company's shareholders but not to potential investors. This ruling was affirmed in a number of cases thereafter.

---

[2] Sasea Finance Ltd vs KPMG (2000) 1 BCLC 236 at 241,242
[3] Barings Plc. vs Cooper & Lybrand (1997) 1 BCLC 427 (CA)
[4] (1990) BCLC 273

But post the ruling of Columbia Coffee & Tea Pty. Ltd vs Churchill [5] the Supreme Court of New South Wales held that a company's auditors do owe a duty of care to potential purchasers, although since in this case, no reliance was placed on the auditor's report, the auditors were not held liable. This has now been overruled but the law now states that under special circumstances, there may arise a direct relationship between a third party and the auditors. In the absence of such circumstances, an auditor is generally not found to owe any duty to the third party unless he or she intended that person to rely on the statement, or if there is an assumption of responsibility.

Duty as to considerable accuracy

The auditor's function is not just to verify the arithmetical accuracy of the accounts; but that it includes all the particulars required by law and that it presents a correct and honest view of the company's financial standing. Therefore he must examine all the records and books of the company with utmost care and precision.

Detection and Prevention of Fraud

The term fraud is defined as:

An intentional perversion of the truth, for the purpose of inducing another in reliance upon it, to part with some valuable thing belonging to him, or to surrender a legal right. A false representation of a matter of fact, whether by words or by conduct, by false or misleading allegations, or by concealment of that which should have been disclosed, which deceives and is intended to deceive another so that he shall act upon it to his legal injury... A generic term, embracing all multifarious means which human ingenuity can devise, and which are resorted to by one individual to get advantage over another by false suggestions or by suppression of truth, and includes all surprise, trick, cunning, dissembling, and any unfair way by which another is cheated[6].

Fraud basically falls into the following three categories:

---

5 (1992) 29 NSWLR 141(Aust)

6 *Black's Law Dictionary* (Sixth Edition, 1990)

- ***Management fraud*** - when the senior management is involved and they are manipulating the financial statements and misrepresenting the real picture, or theft or improper use of company resources;
- ***Employee fraud,*** which involves non-senior employee theft or improper use of company resources and carrying out of practices and transactions under the table; and
- ***External fraud,*** which involves theft or improper use of resources by people who are neither management, nor employees of the firm[7].

Internal audit staff and external auditors have to perform an essential function of fraud prevention and deterrence as they are up to speed, experienced and trained in the same and can see to it that the loopholes in the system and the risk areas are identified and investigated. Once they are identified, quick action has to be taken to address and rectify them. The internal processes and programs have to be tested at regular intervals to test their effectiveness.

In order to do this, the auditor needs to ensure that effective anti fraud programs are in place, which not only prevents fraud but also assists in its detection and cure.

This can be done by

1. Observing the modus operandi of financial reporting;
2. Overseeing the internal audit and control system; and
3. Reporting findings to the management.

Some of the factors that indicate the existence of fraud are unavailability of original documents, unusual relationships, unauthorized transactions, and unexplained items in the accounts, sudden increase or decrease in trends, employees given liberty to access system and records, disparities in accounts and spur of the moment adjustments in the books.

Once the fraud is detected, the auditor can investigate it further by authentication of original documents, impromptu tests and location visits, contacting major customers and suppliers, interviewing the personnel and testing the veracity of computer records.

[7] http://www.aicpa.org/audcommctr/toolkitsnpo/Fraud.htm

The auditor should then report of this to the director or the management, unless circumstances are such that their involvement is suspected. The possibility of detection is a lot less in such cases. However, then the auditor can either approach a third party or consider legal counsel.

The auditor is at all times, required to act with reasonable care and skill, but he is not required to always be on the lookout for fraud or a lie, unless he comes across such information or situation which is unusual and instigates him to act with suspicion of a professional man of reasonable competence. An auditor's main function is to assess the financial position of the company and depict the same in the accounts i.e. the balance sheet and profit and loss account. There is no hard and fast rule for defining reasonable skill and care and that varies from case to case. If there are suspicious and unusual transactions and features in the accounts or other prima facie reasons, reasonable skill and care has to be exercised.

An auditor is not to be confined to the mechanics of checking vouchers and making arithmetical computations. He is not to be written off as a professional "adder-upper and subtractor." His vital task is to take care to see that errors are not made- of omissions, commissions or downright untruths. To perform his duty properly, he must come to it with an inquiring mind- not suspicion or dishonesty.

FORENSIC ACCOUNTING CONSULTANTS

In some situations, the company has to look beyond the independent audit team for expertise in the arena of fraud prevention. In such cases, CPA forensic accounting consultants can provide additional assurance or advanced expertise, since they have special training and experience in fraud prevention, deterrence, investigation, and detection. Forensic accounting is unique in that it combines accounting with investigation. The bloodhounds-as opposed to the watchdogs- the auditors attempt to sniff out fraudulent transactions from the financial records of banks and companies.

LIABILITIES OF AN AUDITOR

The auditor has a fiduciary relationship vis-à-vis the shareholders of a company, therefore he has a moral obligation to see that ensuring that the statements issued are made with the utmost skill safeguards their interests and care and depict the true and fair state of affairs of the company.

Section 233 of the Companies Act imposes a penalty for on the auditors for non-compliance of Sections 227 and 229 with payment of fine if there is wilful negligence and default. The auditor may have to compensate the members or shareholders of the company who have suffered losses attributable to the negligence in performance of the auditor's duties. The auditor may be held liable in tort for fraud and if there is negligence in detection of errors that may cause loss to the company.

In order to hold the auditor liable for fraud, the following conditions must be satisfied:

1. that the statement signed by the auditor is untrue and false;
2. that he knew it to be untrue either or did not apply reasonable care and skill;
3. that he intended the report to be relied on by others; and
4. that the parties on relying upon the report suffered loss.

The Companies Act, 1956 imposes a Criminal liability under Section 628 on any person who makes a false or untrue statement through any document like balance sheet, profit and loss account, return, prospectus, intentionally, thereby causing a loss to the people who rely on such documents.

The auditor who knowingly doesn't make a fair and honest report of the company's financial position in any report, certificate, return, prospectus or other documents, and makes false statements therein is liable.

The shareholders interests are dependant on the degree of care and skill applied by the auditor to draw up an accurate and honest report of a company's state of affairs. Therefore, the auditors should employ utmost good faith, care and vigilance in the carrying out of their duties. If there is the slightest bit of suspicion of the legality and integrity of a record or transaction, the auditor is under a duty to investigate and report it, before he certifies it to be true.

THE SATYAM SCAM

January 7, 2009 was a black letter day in the history of Indian Corporate industry. B. Ramalinga Raju, Founder and Chairman, Satyam Computer Services, on this day confessed to its Board of Directors the accounting scam, which eroded nearly $2 billion of wealth that belonged to 3 lakh shareholders and the their net worth dropped from a positive Rs 8,529 crore to a negative Rs 278 crore. This fraud was not committed overnight; it was building up continuously from over years. The role of Satyam's auditors is under scanner. They ignored some of the obvious indications of embezzlement and thus failed to catch on the massive scam, which could have been caught much before it acquired the 'massive' status. Some of such indications are as follows:

Decrease in holdings

The holdings of Raju and his family decreased from 15.67% in 2005-06 to 8.61% in September 2008 and finally, early this year to a meagre 2.3% without anybody noticing. Further, in 2006, he transferred these shares to his family's company, SRSR Holdings Pvt. Ltd. from which he took out loan using his shares as collateral. It cannot be said that Raju did not benefit from it. He benefited, and that too substantially.

High amounts of debt despite easy cash positions

Satyam closed 2007-08 with $56 million of debt, even after having about $1.2 billion of cash. Further, an enormous amount of Rs.4462 crore was lying unused in its current account. This amount was neither distributed among shareholders in the shape of dividend, nor was it used to earn valuable interest, as it is usually done. But neither independent board members, nor the auditors seemed to question this.

Imaginary fixed deposits

Raju admitted that Satyam's fixed deposits which supposedly grew from Rs. 3.35 crore in 1998-99 to a massive Rs. 3320.19 crore in 2007-08 are all fake. The auditors are supposed to have an independent bank confirmation of such things in the form of a bank statement and should have obtained certificates from the banks on the tax deducted on the interest accruing on the fixed deposits.

1. Undisclosed pledges

Satyam also procured a loan of about Rs. 1230 crore without appropriate disclosure.

The abovementioned points may just be the tip of the iceberg, and there were many more violations by the computer giant, including insider trading and fudging up of cash reserves and bank deposits. It wasn't as if no one was ever suspicious of Satyam's dodgy numbers. It was accused of tax fraud and insider trading back in 2003. However, the company police- including the auditors seemed to ignore the accusations.

CONCLUSION

The shareholders of a company place very high reliance on the auditor's report, which apparently shows the true and fair view of the accounts of a company. The auditors should perform their duties with utmost care and vigilance to ensure that there are no illegal or improper transactions.

But still, Satyam has happened. The role of the UICAI and MCA should now not just be confined to punishing Satyam's auditors, but they should also re-examine the present system to strengthen and intensify internal audit system. Some of such remedial steps, which may be taken, are as follows:

1. Appointment and remuneration of auditors should not be left to the companies they audit, as the fees can easily influence the auditors report. A better option would be to pool in money and hand it over to the stock exchanges that can appoint auditors. This will make the auditors answerable to the bourses and not corporate executives;

2. Forensic auditors should be used to unearth evidence of wrongdoing, which needs a combined team of people from the police or the CBI, lawyers and audit professionals with an adversarial approach;
3. Other than forensic audits, even investigative audit techniques could be applied wherever major weaknesses in internal controls or their implementation are found. An investigator does not accept a stated fact as correct unless it is substantiated;
4. The professional firms should introduce partners' audit review and partner-rotation programs. This will also ensure healthy participation on the part of the partners; and
5. The auditors should also ensure that the audit is conducted in accordance with the Auditing and Assurance Standards (AAS), which are is benchmark on which the quality of audit performance can be measured, and any material departure should be disclosed. AAS-4 talks about the Auditor's responsibility in considering fraud in audit of financial statements

Besides these, steps should be taken to ensure that the auditors are fulfilling their general duties of getting third party evidence, identifying and assessing the risk of material misstatement in financial statement due to fraud, contacting major customers/suppliers etc. These steps will bring in light fraud but won't stop them. Strong laws have never deterred criminals. But if there is a comprehensive paperwork to support it, over a period of time, it can be detected by common sense approach instead of mechanical approach.