

Cosy Auditor-Management Relationships and Corporate Frauds in India

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Abstract

Corporate accounting frauds are increasing in India. The unholy nexus between auditors and managements is allegedly the key reason for the rising trend in the country. Though the Satyam scandal (2009), the largest corporate fraud in the history of the country, spurred thorough audit checks, the series of frauds alleged thereafter call for more improved measures for prevention. The recent probes by Serious Frauds Investigation Office (SFIO), the investigation arm of the Ministry of Corporate Affairs (MCA) in India, into the alleged frauds since 2008 in 83 companies is quite evident for the signalling scenario in the country. Auditors' involvement in different forms in these frauds have been seriously deliberating in the country demanding measures to curb the situation. The very recent move in the new Companies Bill for the formation of National Financial Reporting Authority (NFRA) to look after the quality of audit, compliance by auditors, and also the disclosures they make is a significant move in the direction to remedy the situation. Alarmed by the magnitude of the situation, the capital market regulator SEBI (Securities and Exchange Board of India), insurance regulator IRDA (Insurance Regulatory and Development Authority), and telecom regulator TRAI (Telecom Regulatory Authority of India) have also been indulging in severe measures to improve the situation. It is in this context that the paper sheds light on the selected scandals to dig out the involvement of the auditors in these scandals.

Keywords : accounting frauds , auditing frauds , corporate scandals , cosy auditors , corporate frauds in India

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The incidences of corporate frauds, in one way or the other, are on the rise in India (KPMG, 2012). The India Frauds Survey Report 2012 released by KPMG India states that around 59% of the corporate frauds in India involve accounting frauds resulting from misstatements in financial statements. Why do managements plan for accounting frauds? Most of the time, managements are pressured or willingly alter financial statements for short term benefits primarily in the form of overstated performance for manipulating share price (KPMG, 2012 ; Wikipedia, Accounting Scandals, 2013). Conceptually, financial statement fraud is a type of fraud that causes a material misstatement in the financial statement by deliberate fabrication of accounting records; suppression or omission of transactions, omission of balances or disclosures from the financial statements; or the misapplication of financial reporting standards. Imagine the situation if these misstatements are left unchecked or are given a green signal by the external auditors who must act as independent watchdogs.

Why do so many corporate accounting frauds happen in India? According to the words of the Corporate Affairs Minister - "such a nexus (cosy relation between the management and auditors) would not be allowed anymore as lawmakers (in India) have become smarter after the Satyam scam." Identifying or finding frauds through financial statement verification is a very serious issue involving greater amount of skill and integrity. International and national auditing standards and practices are at the fore to lead the process. However, relaxing audit standards and diluting audit integrity are all the way mounting in India, challenging regulatory bodies and governments to intervene with strong preventive measures.

Research Problem

India has been amongst the fastest growing economies in the world in the last decade. It has remained relatively unaffected by the global economic crisis on account of its strong fundamentals of the economic policy. However, despite this situation, corporate scams have downgraded the confidence of international and domestic investors,

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especially since 2009 (KPMG, 2012; Wikipedia, Accounting Scandals, n.d). The need for improving governance and ethical culture across public and private sector companies has never been felt as acutely as it is being felt now (KPMG, 2012). Interestingly, watchdogs often flag misstatements in the financial reports. Instances evidencing auditor-involved frauds are all the way disturbing the country to remedy the situation. No doubt, necessity is the mother of invention. Chinese philosopher Lao Tzu's words, "A journey of a thousand miles begins with a single step," applies to the case of regulatory and governmental intervention in the light of the soaring corporate and financial statement frauds in India. The Satyam scandal (2009), the largest corporate fraud ever in the history of the country, though cemented measures for thorough audit checks, the series of frauds alleged thereafter call for more improved measures for prevention. The recent probes by Serious Frauds Investigation Office (SFIO), the investigation arm of the Ministry of Corporate Affairs (MCA) in India, into the alleged frauds since 2008 in 83 companies are quite evident of the signalling scenario in the country. Auditors' involvements in different forms in these frauds have been seriously deliberating in the country, demanding measures to curb the situation. Terming the 'cosy' relationship between management and auditors as key to accounting frauds, the Corporate Affairs Minister, Mr. Sachin Pilot, said it is high time to tackle the issue ("Satyam made us smarter; auditors can't get cosy with management: MCA," 2012). The proposed formation of the National Financial Reporting Authority (NFRA) to look after the quality of audit, compliance by auditors as also the disclosures that they make is a significant move in the direction to remedy the situation. Warning the magnitude of the situation, the capital market regulator SEBI (Securities and Exchange Board of India), insurance regulator IRDA (Insurance Regulatory and Development Authority) and telecom regulator TRAI (Telecom Regulatory Authority of India) have also been taking severe measures to improve the situation.

The KPMG (2012) report on corporate frauds in India emphasizes that increased performance pressure both on employees as well as on organizations in the current economic environment and rising aspirations have a leading role to play in the increased occurrence of fraud in most organizations. The pressure to perform in the current economic environment has never been higher and it is a fact that one needs to work much harder to get the same results, the report adds. In short, the changing dimensions of performance checks and the increasing amount of globalization impacts and its linkage to stock markets have been transforming the business scene complexity for managers (Bhasin, 2012 ; Shirur, 2011). Survival, sometimes, through all possible means may be essential for managements. Enriched financial reports by fictitious means with auditors' certification ,therefore, become management lifelines. Events evidencing management-auditor nexus to camouflage frauds are many. Being watchdogs, auditors are expected never to back-scratch with or without any undue advantage. Irrespective of the number of evidencing events, even a single similar event is enough to stain the sensibility and sensitivity of the auditing profession. The review of related literature including the tough talk by responsible authorities provoked the author to pursue some of the recent events in India, including the Satyam accounting scandal to explore the nature and the involvement of auditors in these scandals.

Methodology and Materials

The study is exploratory in nature using 'content analysis' methodology to pursue the five selected cases of corporate accounting frauds in India to elicit its nature and involvement of auditors in the form of negligence or otherwise which brewed up frauds without detection for a long period of time. Thus, the present study is primarily based on 'secondary' sources of data, gathered from the related literature published in newspapers, books, journals, statements, and reports. The frauds intended for perusal include the Satyam Scandal (2009), Reebok Scandal (2012), Niira Radia Group Corporate Scandal (2012), Sesa Goa Financial Fraud (2009), and the Nokia India Income Tax (IT) Scandal (2013). The cases are analyzed primarily on qualitative basis and ,therefore, exclude the use of any quantitative or statistical tools for analysis. Results of the analysis are reported to plausibly understand the nature of the frauds first and evidences for auditors' negligence or otherwise next.

Case Analysis, Results, and Discussion

The exploration of the five selected cases of corporate frauds is done in the backdrop of a very recent report published in The Economic Times that will help us to comprehend the severity of the scenario of accounting fraud in India ("SFIO detects siphoned funds worth INR 5,607 Cr," 2013). The report details the MCA minister's promulgation

about the findings of a SFIO investigation in 18 companies in the past three years (2009-10 to 2011-12) which divulged siphoning of funds worth nearly US 1121.4 million (INR 56,070 million). The report carries the minister's assurance for necessary steps, including revamping of existing machineries to keep corporate frauds in check. The increasing numbers of corporate frauds have been a hot topic of discussion in the Parliament, where the MCA minister was showered with a number of questions seeking clarification on the issue. Obviously, after the much discussed Satyam Accounting Scandal and the consequent vigilance, corporate frauds are getting more and more divulged in India. These backgrounds give a boost for analyzing the selected cases to reveal the nature of frauds and the watchdogs' laxity in keeping the frauds in check.

➤ **Case 1 - The Satyam Scandal (2009)** : The Satyam scandal, dubbed as the Asian Enron, was the largest accounting fraud ever in the history of corporate India. The company was named after the Sanskrit word "Satyam," a synonym for the English word "truth". The IT firm, launched in 1987 with 20 employees, grew up rapidly into a global concern with US\$ 2.1 billion by March 2008. The five year average results of operations ending in March 2008 were commendable, figuring a 300% increase in share price during the half decade. However, the shooting star fizzled out in early 2009 following the confession of Mr. Ramalinga Raju (henceforth, Mr. Raju), the then Chairman of the Board (CoB) of Satyam Computer Services Limited. He wrote a letter to the Board of Directors and the Securities Exchange Board of India (SEBI) admitting fraudulent financial reporting and resigned from the chairmanship of the company. In his letter, Mr. Raju stated that the company's balance sheet for the quarter ending on September 30, 2007 included inflated cash and bank balances of up to \$1.44 billion, understated liabilities worth about \$300 million, and non-existent accrued income of \$86 million (Basilico, Grove, & Patelli, 2012; Bhasin, 2012 ; Shirur, 2011). Altogether, the fraud figured US\$ 1.47 billion (INR 7,800 crores) involving both the manipulation of balance sheets and income statements of the company (Bhasin, 2012; Basilico, Grove, & Patelli, 2012; "Satyam made us smarter; auditors can't get cosy with management: MCA," 2012).

The history of the company and its details of operation are irrelevant to the objective of the present paper. What is important here is the nature of fraud and the negligence of its auditors. Mr. Raju confessed that he had been manipulating the company's accounts for several years, nearly seven years (Bhasin, 2012). No doubt, it was a continuing fraud. Bhasin (2012) and Basilico, Grove, and Patelli (2012) observed that the company's global head of internal audit created fake customer identities and generated fake invoices against their names to inflate revenue. The global head of internal auditor also forged board resolutions and illegally obtained loans for the company. Naturally, severe criticism rose against the Head of the internal audit followed by criminal action against him by the Central Bureau of Investigation (CBI) in India. Is this the model example of efficient audit, internal or external? The remarks of Caraballo, Cheerla, and Jafri (2010, p.6), "The Satyam scandal is the classic case of negligence of fiduciary duties, total collapse of ethical standards, and a lack of corporate social responsibility," are quite a warranting statement about the event.

Coming to the external auditing part, the PricewaterhouseCoopers (PwC) were auditing the books of Satyam from June 2000 until the discovery of the fraud in 2009. According to the words of PwC, "The audits were conducted by Price Waterhouse [sic] in accordance with applicable auditing standards and were supported by appropriate audit evidence" (McKenna, 2009). The claim of PwC, which had a long nine years of standing with the books of accounts of Satyam, that they were unaware of the cooking process is hardly believable. In contrast, Merrill Lynch, the U.S. bank, discovered the deception in just ten days (Bhasin, 2012 ; McKenna, 2009). This is a clear indication that the auditors were either grossly inept or were compliciting with the company in committing the fraud. Notwithstanding, the claim of PwC, unrelenting criticisms were harshly aired against the audit firm for failing to detect the fraud (Bhasin, 2012). Noticeably, Satyam paid PwC twice what other companies charge for audit. This also raised strong doubts about whether PwC was an accomplice in the fraud (Bhasin, 2012; McKenna, 2009). The comments of the MCA Minister years after the scandal (2012) are quite concluding, "sometimes auditors get into too cosy a relationship with the management, which creates a lot of problems. Satyam made us smarter; auditors can't get cosy with the management" ("Satyam made us smarter; auditors can't get cosy with management : MCA," 2012). Naturally, the factors which contributed to the fraud were many, however, the external auditors who certified the accounts of the company were a symbol of trust for the stakeholders despite the legality or otherwise related to the certification process. Unfortunately, after the scam, the trustworthiness of the watchdogs has become suspect.

➤ **Case 2 - The Reebok Scandal (2012)** : Reebok International Limited, a subsidiary of the Adidas group (German company), since 2005, is a producer of athletic shoes, apparel, and accessories. The Indian arm of Reebok allegedly committed INR 870 crore fraud in March 2012 under its former Managing Director, Mr. Subhinder Singh Prem and former Chief Operating Officer, Mr. Vishnu Bhagat. It is deemed as the second biggest corporate scandal after Satyam (some other events with higher magnitude are pending investigation), and the involved officials have been booked for falsification of records, diversion of funds, creating loss for the company, and wrongful gain (Choudhury, 2012; "Reebok India alleges Rs 8,700 crore fraud by former MD, COO," 2012). Large scale product pilfering, fudging of accounts, and fictitious sales creation were alleged to be involved in the process, and the tainted accounts were managed to be certified by the Indian audit firm N. Narasimhan & Co. (Choudhary, 2012 ; "Reebok India alleges Rs 8,700 crore fraud by former MD, COO," 2012). The company even maintained secret sales depots to store stock returned by dealers and distributors and thereby inflated sales by choosing not to account for it for a long time (Choudhary, 2012).

Probes by SFIO and other agencies about the scandal are on the respective trails. Principled by professional ethics, the Institute of Chartered Accountants of India (ICAI), the body that regulates auditors and accountants in the country is independently probing the fraud case to dig out whether there were instances of professional negligence by the chartered accountants. Reading between the lines, the initial responses of Mr. Shah, the then ICAI President is quite penetrating. "We are yet to initiate an investigation, but prima facie, there seems to be critical lapses in the way the company's auditors functioned. Without the knowledge of auditors, both internal and statutory, such a huge misappropriation of funds is impossible." More importantly, Choudhury (2012) reported that "the parent company, Adidas AG had hired the forensics team of KPMG to probe into the matter in 2010, in a project code named "project diamond." But KPMG gave a clean chit to the two dismissed executives. Confusion! who are auditors? Are they any different from fraudsters?

➤ **Case 3 - Niira Radia Group Corporate Scandal (2012)** : Nine companies associated with the corporate lobbyist, Niira Radia, are now under the scan of the SFIO alleging serious financial irregularities. The SFIO has issued notices to all the companies seeking detailed information regarding financial accounts and transactions in the last few years (Dey, 2012). The investigation has been ordered following the report of Registrar of Companies (RoC) in July 2012 alleging serious violations of various provisions of the Indian Companies Act, 1956. The nine companies under scrutiny are Vaishnavi Corporate Communications, Vaishnavi Advisory Services, Leisure Clubs India, Claro Consultancy, Magic Airlines, Maansi Agro, Crownmart International India, Vitcom Consulting, and Neucom Consulting Pvt. Ltd. ("Nira Radia's companies under SFIO scanner: Corporate Affairs Minister Veerappa Moily," 2012). The RoC submitted the report after examining the balance sheets of the companies for the years 2008-09 and 2009-10 and has reported non-compliances in all the companies. However, the size and composition of financial irregularities are yet to be disclosed. Violation of disclosure requirements as per the Companies Act by some of these companies regarding bulk revenue from consultancy business from top business groups in India is one of the irregularities alleged and reported by the RoC. Wrongdoings relating to write-offs, payment of donations, loan for purchase of capital assets, intra-company transactions, and share issue application money are also among the serious charges pending investigation by SFIO (Dey, 2012; "Nira Radia's companies under SFIO scanner: Corporate Affairs Minister Veerappa Moily," 2012).

Believably, the auditors' certified accounts of these companies are now under consideration of the Serious Frauds Investigating Agency of the country. The submitted report of the RoC regarding serious financial wrongdoings in the companies and the much expected detailed investigative report from SFIO on the issue are all about the numbers in the audited financial statements of these companies. Obviously, anyone can doubt the context. Why are 'certified accounts' by 'qualified auditors' this much unreliable and controversial? Is auditing an unholy business of certification? What about investors' confidence? And finally, who is responsible?

➤ **Case 4 - Sesa Goa Financial Fraud (2009)** : Sesa Goa, a Vedanta Group-owned company, is an iron ore mining major in India. In 2009, the SFIO was asked to investigate the affairs of Sesa Goa, following a report of the Registrar of Companies (RoC), which 'prima facie' found the company guilty of fudging invoices in addition to other severe charges ?("Sesa Goa Faces Over Rs 1K-Cr Fraud Case," 2011). After an investigation, spanning over one-and-a-half

years, the Serious Fraud Investigation Office (SFIO) found that the company has over-invoiced import receipts of coking coal by INR 14.6 crore and also sale of iron-ore by INR 42.51 crore, while under-invoicing exports by INR 1,002 crore. The SFIO has also recommended prosecution against Sesa Goa's Managing Director and the Company Secretary for violations under the Indian Companies Act, 1956. The report also accused the company's independent directors and statutory auditor of non-cooperation with the investigations, and has also recommended prosecution on this basis ("SFIO recommends prosecution of Sesa Goa for over and under-invoicing of export/import of over INR 1000 crore," 2011).

However, a second investigation was conducted after several representations were made by Sesa Goa to the SFIO. The probe agency, which had found various irregularities to recommend prosecution on nine counts against the company and its management, changed its stand from time to time. When the second SFIO report came, it said, had Sesa Goa provided sufficient facts and explanations earlier, the conclusion would have been in favour of the company. Finally, the MCA has directed the SFIO not to initiate prosecution proceedings against the company and its management ("MCA asks SFIO not to initiate prosecution against Sesa Goa," 2013). Will a third report bring a different conclusion? Not privy to the evolving drama, let me substantiate my point relating to the negligence of the auditors. Evidently, SFIO had recommended prosecution against statutory auditors of the company for not-cooperating with the investigation process. What happened to the auditors? Is it possible to under or over invoice import and export without the notice of the auditors? What can an auditor dig out through the audit process? If accounting frauds cannot be brought to light, why do we audit at all ?

➔ **Case 5 - Nokia India IT Scandal (2013)** : Nokia India Ltd., the India subsidiary of the Finnish telecom major, is now facing investigation under a serious allegation of tax evasion amounting to INR 3000 crores ("Nokia's Chennai Plant under tax scanner," 2013). The company started functioning in 2006 and is today the largest production facility of Nokia employing nearly 9000 people ("Tax probe not in tune with fair play: Nokia," 2013). The crux of the case alleged in January 2013 is that Nokia India has been downloading software from its parent company in Finland and used it in the mobile handsets manufactured in India. Payment of royalty for downloading the software has been made without making any deduction for income tax while such payments were attracting income tax of 10% of the amount paid. This was continuing for the last six years. Moreover, the tax department has alleged that Nokia changed its accounting policy and was also in the process of reorganizing the existing business model to bypass certain direct and indirect tax liabilities ("MNCs like Nokia, Shell lash out at 'unacceptable' tax demand", 2013). The Income Tax (IT) authorities conducted a search in the company premises with the help of Central Forensic Science Laboratory (CFSL) before serving notice to the company to pay the evaded amount ("MNCs like Nokia, Shell lash out at 'unacceptable' tax demand," 2013 ; "Tax probe not in tune with fair play: Nokia," 2013).

The Indian arm of PricewaterhouseCoopers (PwC) is auditing the accounts of the company and they have been called for interrogation as part of the investigation ("MNCs like Nokia, Shell lash out at 'unacceptable' tax demand," 2013 ; "Nokia India auditors appear before income tax department," 2013). Kandavel (2013) reported on reference to an IT official, "The evidences gathered so far clearly indicate that PwC has advised Nokia and they were aware of the tax evaded and the accounting practices." Can auditors cosy up with the management to organize irregularities is the question that needs to be probed.

Are Regulators Strong and Vigilant □

The rising number of frauds in the corporate sector has been a serious debate even in the Indian Parliament. The government is managing the queries in the Lok Sabha (the powerful Lower House of the Parliament) by fielding numbers regarding frauds detected, persons prosecuted, and so forth, as vigilance from its part to tackle the situation. Assuring necessary steps to keep corporate frauds in check, the MCA has revamped the existing Market Research and Analysis Unit of the SFIO to enable them to function as an intelligence unit . However, concrete measures for curbing financial statement frauds at the source itself that remain undetected for several years is still a menace wanting serious and definitive action from the regulators and the government. Indisputably, the auditors have to carry out their assignments with utmost professional care and sincerity to uphold the public's faith in them. This, in turn, creates a demand for ensuring the reliability of the audited accounts by professional auditors. Unfortunately, in all the cases

discussed above, the auditors' involvement in the form of negligence or cosy relationships have made the accounting and auditing profession a travesty in our country. The ICAI, which issues audit standards in India through its arm – Auditing and Assurance Standards Board - highlights the duty of the auditors to ensure that the audit standards are followed without fail and also to remind the auditors about the consequences for non-compliance. However, the financial statement frauds unearthed during these days and the negligence or cosiness of the auditors in perpetrating such frauds are, no doubt, alarming.

Obliviously, the repeated promulgation of the authorities on the number of detection and prosecution in the scenario are only post-mortem analysis. The recent announcement in the Companies Bill 2012 for the formation of the National Financial Reporting Authority (NFRA) as an overarching body to oversee the accounting and auditing profession regarding frauds is a welcome relief to all concerned. Though the ICAI has its own mechanism to serve the above purpose, the reported non-compliance rate is an alarming question about the proper functioning of the system (“New Watchdog,” 2013). Above all, the new and improved provisions in the forthcoming new Companies Bill for preparation of consolidated financial statements, restatement of financial information, accounting for amalgamations and court schemes, depreciation of fixed assets, and uniform financial year are reported to be some of the concrete measures to curb financial statement frauds. The unprecedented greater vigilance by the capital market regulator (SEBI), insurance regulator (IRDA), and telecom regulator (TRAI) by indulging in severe measures to improve the situation are also positive signs promising a better future.

Conclusion

Believably, frauds can set in any form and at any time. No terrain or entity is free from the risk of frauds. The corporate sector, which has the onerous responsibility of adding towards the gross domestic product of a nation is prone to different vulnerabilities, including frauds by employees. However, while the management itself is indulging in serious frauds by manipulating accounts and financial statements for private gains by causing loss to the government exchequer and investors, it is quite untrustworthy. The times are shocking and pathetic when the watchdogs (having the responsibility to attest the statement of accounts) negligently and cosily fraternize with ruthless corporate managements to commit white-collar crimes. The measures taken by India to improve the situation, especially in the aftermath of so many corporate frauds, are appreciable. New lessons for the future must be learnt from past experiences. Now, no auditor can audit a company for more than five years in India. The unprecedented greater vigilance on the part of different regulators and a new quasi-judicial body (proposed) to look-after the quality of audit and compliance by auditors are the right steps towards accountability in corporate reporting.

Managerial Implications

The corporate managements that are destined to maximize the wealth of the shareholders while involved in accounting frauds to eat short-term benefits are really maligning the corporate sector in the country. The so called “watch dogs” are also hand-in glove with the managements to cook frauds. The study exposes that the management-auditor involvement in corporate accounting frauds can serve as an eye-opener both for managements and auditors to keep them away from unethical practices. A country targeting superior growth rates in the future should have a corporate accounting and auditing system free from frauds, that is transparent enough to build investors' confidence, bring new investments, and sustain corporates from unwanted risks.

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