

Inside the audit lapses that led to IL&FS crisis

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How did auditors fail to notice a crisis that had been brewing on IL&FS' balance sheets for several years?

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Mumbai: Every time there is corporate scam, audit firms and auditors are the first ones to be blamed. This time, too, after the Infrastructure Leasing and Financial Services Ltd (IL&FS) crisis, the auditors, especially the “big three”—EY, Deloitte and KPMG—are in the dock. Yet, larger questions remain about the changing role of the Institute of Chartered Accountants of India (ICAI), besides India's auditing rules.

As things stand, IL&FS and its vast network of subsidiaries has now become a PR nightmare for the big three.

Last September, IL&FS had defaulted on its debt obligations, triggering a liquidity crisis in the financial services market. IL&FS and its subsidiaries owe ₹99,354 crore. The government was swift to act and replaced the IL&FS board with hand-picked nominees in October.

Subsequently, protracted rounds of investigation by agencies, a forensic audit, the board's own research and analysis to understand the depth of the rot, and the government's recourse to the legal route to resolve the crisis followed.

The affiliates of Deloitte Haskin and Sells Llc, KPMG India, and EY India Ltd were auditors of IL&FS and its subsidiaries—IL&FS Financial Services Ltd (IFIN) and IL&FS Transportation Networks Ltd (ITNL). Probe agencies, including the Serious Fraud Investigative Office (SFIO) and National Financial Regulatory Authority (NFRA), are also probing the role of auditors.

In a recent interview, ministry of corporate affairs (MCA) secretary Injeti Srinivas said the auditors have a lot to answer for: “We are not expecting an auditor to detect a needle in a haystack, but if an elephant is in a room, they ought to find it.”

Separately, the ICAI, the accounting regulator, initiated action against a KPMG affiliate, BSR and Co. Llp, for professional misconduct under the Chartered Accountants Act, 1949.

“Professional or other misconduct” is described as an act of omission by auditors, whose job is

to provide a true picture of a company's accounts. According to the ICAI, the auditors did not highlight the Reserve Bank of India's (RBI's) inspection report, which had labelled IFIN as over-leveraged, besides failing to report negative cash flows and adverse key financial ratios. A copy of the notice was reviewed by Mint.

BSR approached the Delhi high court even before the ICAI could start proceedings, and the court stayed the order on 25 February on the ground that the ICAI had relied on media reports and did not possess any findings of its own.

The protracted legal battles and the charges of fraud (former IL&FS vice-chairman Hari Sankaran was arrested in April) show the wide-ranging magnitude of the fallout. Can external auditors really be trusted to tell the truth about a company if they are also angling for consultancy work from the same entity? Can a corporate behemoth, which has hundreds of group entities, be trusted to not hide shady transactions in its subsidiaries? Can existing regulations be trusted to catch up with an erring company before the problem blows a ₹1 trillion hole in the economy? Well, essentially, the question in the aftermath of the IL&FS crisis is all about trust—concerning auditors and regulators, as well as the corporate entity.

FIRMS IN THE DOCK FOR AUDIT FLAWS

IL&FS group and its vast network of 348 subsidiaries as of March 2019 owed ₹99,358 cr. Its two major subsidiaries, ITNL and IFIN that account for more than half of its debt, used the services of EY, Deloitte and KPMG as primary auditors.

	IL&FS	ITNL	IFIN
2018-19	SRBC & Co. (EY)	SRBC & Co. (EY)	BSR (KPMG)
2017-18	SRBC & Co. (EY)	SRBC & Co. (EY)	Deloitte and BSR
2016-17	Deloitte Haskin and Sells	Deloitte and SRBC& Co. (EY)	Deloitte Haskin and Sells
Till 2015-16	Deloitte Haskin and Sells	Deloitte Haskin and Sells	Deloitte Haskin and Sells

Even the ICAI's inordinate urgency to act against BSR has come under suspicion, since it is being viewed as a manoeuvre to assume jurisdiction on IL&FS's audit lapses. "With (the) NFRA coming into existence last year, the government wants to use the watchdog and its powers to not just penalize individuals involved in the audit, but also audit firms. There were questions about who should examine the role of auditors, but now it is more or less settled that

it should be (the) NFRA," said a government official. So, the question is: Was the ICAI trying to shield the firms from penalty or debarment?

After all, only the NFRA has the powers to penalize individual auditors and firms, under the Companies Act, 2013, a provision that is missing in the Chartered Accountants Act. The penalty for an individual auditor is ₹1 lakh to five times the audit fee. For firms, it is ₹10 lakh to 10 times the audit fee.

The NFRA can also debar an individual or a firm for six months to 10 years—the biggest source of concern for audit firms. However, debarment, or any penalty, would first need to pass the MCA's smell test. After the MCA's approval, the proposed penalty would need to be approved by the National Company Law Tribunal. At this stage, the auditor can present its case to prevent penal action.

The new IL&FS board has issued a show-cause notice to the auditors for alleged negligence, and can seek damages from them. An IL&FS spokesperson, however, declined to comment.

After a series of interactions with various stakeholders, Mint has tried to piece together what went wrong in the IL&FS and IFIN audits. The answer is not that straightforward. But one thing is clear: No company collapses merely due to an auditor or an audit failure, but an audit failure does contribute significantly to the collapse of a company.

Last line of defence

External auditing is the fourth line of defence...the others are the operating management, the risk and compliance board, and internal audit. "External auditors are appointed only because the other lines of defence may not be fully trusted," said R. Narayanaswamy, a professor of finance and accounting at the Indian Institute of Management, Bangalore.

There are a host of allegations against the auditors, from missing out on the sprawling IL&FS subsidiary empire and not highlighting the asset-liability mismatch on the company's books, to inappropriate valuation of assets, poor recognition of non-performing assets (NPAs), and non-detection of circular rotation of funds between group entities.

The glaring failures prompted the government to set an example with this case. "Do the auditors work for the management or for stakeholders. Can auditors blindly accept the version of the management and rely on comfort from management?" asked a senior SFIO officer.

In an emailed response, a BSR spokesperson said: "We transitioned into the audit of IFIN as joint auditors only recently in FY18. We were not the auditors for IL&FS or any other material subsidiary of IL&FS. We stand by our audit, which was performed in line with the applicable auditing standards and regulations, and are fully committed to cooperating with the regulatory authorities."

Deloitte, which was the auditor of the three companies for almost a decade (see graphic), said: "The investigation on the company (IL&FS group) is in progress and we are cooperating fully."

EY declined to comment, but said it is cooperating with investigators.

"There was hardly any audit work done. It is a sheer case of gross negligence," said Amarjeet Chopra, former president of the ICAI. Due to such suspicion, the MCA is now looking at reopening and recasting IL&FS' accounts to get a clearer picture and to fix accountability.

After taking over as the government-appointed chairman of IL&FS, Uday Kotak had said the number of subsidiaries at IL&FS (348) was much higher than the reported 169. "Many of these additional subsidiaries are special purpose vehicles (SPVs) in the manufacturing and road building sector. The auditors had limited visibility on these," said an auditor with the big three, requesting anonymity.

Here is where rubber meets the road: Can the principal auditor look into the audit of subsidiaries to figure out the financial position of group entities that are intentionally hidden behind convoluted structures? Well, there are grey areas.

The ICAI-prescribed regulations do not allow the principal auditor to look into the audit of subsidiaries. "We can only go by the audit report made by the auditor of those subsidiaries. So, if the subsidiary reported lesser number of subsidiaries, we cannot comment due to the lack of direct line of sight. We can make an inquiry, but not a re-audit," the auditor added.

International laws are clear on this. The principal auditor is expected to review even the subsidiaries. Armed with this hindsight, the Securities and Exchange Board of India has now issued a circular, mandating listed entities to conduct a limited review of the audit of all the entities/companies whose accounts are to be consolidated with it. This is to ensure that, in future, principal auditors of listed companies have a certain degree of say in the audit of subsidiaries.

The entire IL&FS network had over 35 audit firms, which audited subsidiaries, joint ventures, and associate firms. For instance, IFIN's principal auditors Deloitte Haskin & Sells and BSR had to rely on reports of eight auditors, such as MP Chitale and Co., Sharp and Tannan, Manubhai and Shah Llp, among others.

Solvency crisis

Initially, the IL&FS problem seemed to be an asset-liability mismatch because borrowings were for a shorter period relative to the cash flows from grounded infrastructure projects. It looked like a liquidity problem, which was manageable through an interim lifeline from lenders. However, the company's books are now revealing a full-blown solvency crisis. It means that the auditors should have raised questions about the asset quality.

"While the accounts for multiple years showed the assets as good and properly valued, the valuation of assets seemed inappropriate (in hindsight)," said Dinesh Kanabar, chief executive, Dhruva Advisors, a tax consultancy.

"Asset-liability mismatch and highlighting them falls under the purview of RBI norms. The auditors do not look at mismatches, but raise concerns when the RBI limit is breached. However, when some issues were highlighted (to IL&FS), the risk management and audit committees were comfortable with the mismatch and (therefore) we had no basis to highlight it," said the auditor quoted above.

Limited line of sight

The limited exposure to subsidiaries has been a major hurdle: The inability to detect diversion or misuse of funds.

After taking over as chairman, Kotak had said 90% of the receivables were NPAs, which included arbitration cases and instances of round-tripping. The arbitration cases included road assets commissioned by the National Highway Authority of India. There were also instances of ever-greening and round-tripping involving funds given to third-party borrowers, but mysteriously found their way back, through circuitous routes, as loan repayments by group companies.

The findings of a forensic analysis of IL&FS by Grant Thornton India Llp confirms this. The forensic audit, submitted to IL&FS board last week, also found 107 instances of loan ever-

greening, loans without collateral, and of links between the IL&FS management and borrowers' companies.

Grant Thornton's report also highlights instances of payments and receipts from borrowers on the same date. "It appears unusual that out of ₹390.63 crore of loans provided to the borrower companies, ₹145.33 crore were, in turn, utilized to repay the existing debt obligations," it said.

Auditors said the issue should be addressed to ward off a repeat of the IL&FS debacle.

"We rely on end-use certificates submitted by subsidiaries. We're not going to be verifying the use of the funds. Audit works on a sample, not audit every transaction. Some of these anomalies must have fallen (through the cracks) and may not have been a part of the sample," another auditor said, requesting anonymity.

"IL&FS has a large number of subsidiaries because of the nature of its business. While this in itself is not a problem, it increases the chances of related-party transactions. So round-tripping is always a risk," said Narayanaswamy. "While faulting the external auditors alone may not be fair, these niceties will vanish the moment a fraud comes to light. External auditors are the last line of defence. If they try to play the victim, it would be seen as disingenuous and they will not get anybody's sympathy."

Kanabar said IL&FS was a systemic failure. "The blame cannot lie at the doorstep of just one set of professionals. But auditors should be asked about the kind of independent judgement they exercised, and whether they simply relied on management explanations."

Naryanaswamy, however, said it would be naive to expect the auditors to question the company's management, as they are under enormous pressure to get new businesses, retain existing businesses, and cross-sell non-audit services.

The SFIO's probe against auditors has its roots in the IL&FS investigation, and an anonymous complaint against Deloitte. The complainant alleged that in exchange of giving a favourable view, Deloitte was awarded advisory contracts. "The Deloitte senior leadership was aware of the factual situation on the financial mismanagement and impropriety of IL&FS group," he claimed. "Deloitte had audited the group over a period of 10 years and has been an integral part of the group's unmitigated growth, benefitting in several ways. By being a preferred advisor, several (types of) advisory work was awarded...with substantially high fees."

Deloitte has hired law firm Wadia Ghandy & Co. to examine the veracity of the allegations.

“Let’s face it. Auditing is not very profitable. It is often used as an opportunity to gain entry into a business in order to win consulting contracts. This results in a serious conflict of interest, and this culture must end,” Narayanaswamy said.

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