



ETHICS OF AUDITORS – A CASE COMMENTARY ON SATYAM SCAM

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INTRODUCTION:

Corporate governance refers to a set of systems, principles and guidelines by which a company is governed, as to how the company can be directed or controlled to fulfill its goals and objectives in a manner adding value to the company and also beneficial to all the stakeholders¹.

Good corporate governance means conducting business in a fair and transparent manner, accountable to all stakeholders from board of directors, management, shareholders to employees, customers and society.

Corporate frauds are not only illegal but are tainted by the Breach of Trust of persons holding fiduciary relationship with the company. Fraud can either take place at managerial level called Managerial Fraud or at the employees' level called Fraud by Employee's Association.

THE SATYAM SCAM:

Satyam Computer Services Limited (SCSL) was incorporated as a private company in 1987 full stop the two founding shareholders namely the Raju brothers also being the promoters of the company got the company listed in the Bombay Stock Exchange (BSE) and made it public in 1992.

The company operated on a global level and was incorporated in more than 55 countries with more than 30000 employees serving more than 500 companies of the corporation. In 1999 it was the fastest growing IT company in India. Also being awarded the 'Global Peacock Award' for corporate governance in September 2008, just five years later Mr. Ramalinga Raju confessed to the Satyam scam also known as India's Enron. It came to light that nearly \$1.04 billion in bank loans and cash to be claimed by the company were actually non-existent. The liabilities were also rated lower than the actual quantum. Satyam overstated their income for nearly every quarter over the years.

Mr. Raju has used his personal computer to create numerous bank statements in order to advance the fraud. He inflated the bank income statements by claiming interest income from the fake bank accounts. The company's global head of internal audit also helped him create fake customer identities and fake invoices to inflate the revenue. Further the internal audit forged Board resolutions and illegally obtained loans for the company².

¹Rebecca Furtado, "The Satyam Scandal and its Effect on Corporate Governance Strategies in India", available at: <https://blog.ipleaders.in/satyam-scandal-effect-corporate-governance-strategies-india/#:~:text=Thus%20corporate%20governance%2>

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² Dr. Madan Bhasin, "Corporate Accounting Scandal At Satyam: A Case Study Of India's Enron" 1 *EJBSS* 25-47 (2013).



Global auditing firm Pricewaterhousecoopers (PWC) audited Satyam's book from June 2000 until the discovery of the fraud in 2009. PWC failed in the job terribly as they did not verify the invoices or bank statements. Physical verification wasn't conducted as well. Nearly 7561 fake bills were created and the auditors couldn't spot it for 7-8 years. According to auditing professionals, any reasonable company would have either invested the money into an account bears interest or returned the excess cash to the shareholders. The huge quantum of cash should have served as a 'red flag' for the auditors so as to conclude that further verification and testing was necessary. Either the auditors were grossly inept or were in collusion with the company. PWC initially asserted that it had performed all company audits in accordance with applicable auditing standards. But there is the issue of increase in the audit fee and also PWC using Satyam's tools instead of independent tools of Audit and testing mechanisms.

The scam brought out several loopholes in the Indian corporate governance structure, viz., unethical conduct, fraudulent accounting, insider trading, oversight by auditors, ineffectiveness of the Board, failure of independent directors and non disclosure of material facts to the stakeholders.³

AFTERMATH OF SATYAM:

Immediately after Raju's confession, new board members were appointed to prevent

total collapse of the system and the Indian government immediately started an investigation while limiting its direct participation. SEBI appointed Justice Bharucha, a retired Supreme Court judge to oversee the Auction of Satyam and instill confidence in the transaction. As such, Tech Mahindra bought Satyam for \$1.13 per share.

The investigation charged several criminal cases and the Special Court of Hyderabad in 2015 found the accused guilty of cheating, criminal conspiracy, criminal breach of trust, forgery and obstruction of evidence. The Raju brothers were sentenced to 7 years in prison and fine of Rs. 5 crore each. The convicted persons have appealed against the decision. The Appeal is pending in the sessions court in Hyderabad.

The Institute of Chartered Accountants of India ruled that CFO and the auditor were guilty of 'professional misconduct'. Since the Auditors stated that their audit reports and opinions in relation to the financial statements for the audit period can no longer be relied upon, the CBI charged the partners of PWC for committing offenses of cheating, forgery, using forged documents as genuine, criminal conspiracy and falsification of accounts, fabrication of documents amongst others. PWC were the statutory auditors for the audit period from the quarter ending June 2000 to the quarter that ended in September 2008.⁴

COMMITTEES:

In 2009, the Confederation of Indian Industries set up a task force headed by

³<https://www.moneycontrol.com/news/opinion/what-changed-in-the-legal-landscape-post-satyam-scam-2480623.html>

⁴ N.Kiran, "Case Study on SCSL", *available at:*

<https://www.yourarticlelibrary.com/case-studies/case-study-on-satyam-computer-services-limited-scs/99569>



former Cabinet Secretary Naresh Chandra to suggest reforms. Based on the recommendations of the task force, the Ministry of Corporate Affairs issued the Voluntary Guidelines for corporate governance in 2009

- Independence of directors
- Roles and responsibilities of audit committees
- Roles and responsibilities of Board of companies
- Whistleblower policies
- Separation of offices of Chairman and CEO for independence
- A system of checks and balances
- Terms and conditions of appointment of directors
- In 2010, SEBI amended the listing agreement to include the provision dealing with the appointment of CFO.

The National Association of Software and Services Companies also established a corporate governance and ethics committee. This committee suggested reforms relating to audit committees, shareholder rights and whistleblower policy.

SEBI's Committee on Disclosure and Accounting Standards issued a paper to deliberate on –

- Voluntary adoption of International Financial Reporting Standards (IFRS)
- Appointment of CFO based on audit committees
- Rotation of auditors every 5 years so that familiarity does not lead to corporate malpractice and mismanagement.

CHANGES MADE BY SEBI:

In 2014, the Securities and Exchange Board of India (SEBI) amended the Listing agreement to include provisions relating to

- Establishment of vigil mechanism
- Role of audit committee in case of suspected fraud or irregularity
- Role of CEO and CF pertaining to financial reporting and disclosure to the audit committee

In 2015, SEBI framed the LODR - SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015 that is applicable to all listed companies and provided for stringent guidelines relating to reporting/ disclosure of material events and actual and suspected fraud.

The Companies Act 1956 came to be repealed with the new Companies Act 2013 that brought in several measures intended to benefit the larger stakeholder community. The Act also provides for corporate fraud as a criminal offense. It outlines the responsibility and accountability of auditors and independent directors who are to play a more active role.⁵

ICAI came out with a Guidance note on Reporting on Fraud (ICAI Guidance note 2016) that also put forth a stringent framework for related party transactions.

The serious fraud investigation office (SFIO) has been given statutory status and conferred the power to arrest. The SFIO has been actively investigating cases relating to corporate fraud.

⁵ Anshita Kohli, "Satyam Scam: India's Biggest accounting fraud", *available at*:

<https://thecompany.ninja/satyam-scam/>



ROLE OF VARIOUS REGULATORY BODIES IN THE CASE:

Special Court in Hyderabad:

After SEBI caused the acquisition of Satyam by Tech Mahindra, the accused were found guilty of bogus inflation of the company's revenue, falsified company accounts, falsified income tax returns and fabricated invoices of the transactions.

Mr. Raju was granted bail on the grounds that the limitation period of filing the charge sheet by the CBI had expired. The Enforcement Directorate (ED) filed a criminal complaint against 47 persons and 166 corporate entities headed by Ramalinga Raju, who was then given a six month jail term along with three others by the SFIO.

The judge had sentenced Mr. Raju and 9 others to 7 years rigorous imprisonment but they were given bail by the Special Court in Hyderabad.⁶

SEBI:

Under section 17 of SEBI Act, 1992, the regulatory body took an extensive investigation into the conduct of Satyam and violations of any provisions of the Act, Rules and Regulations thereof. SEBI inspected the available books of accounts and the documents held by the auditors of Satyam, PWC.

SEBI made plans with the government appointed Board of directors and chose a

strategic investor to acquire 51% states that led to the buying of Satyam computer services by Tech Mahindra.

SEBI in its order dated 10th January, 2018 had imposed a ban on all the firms in the PWC network from auditing listed companies and intermediaries (brokers) for a period of 2 years as they were held guilty under the Satyam scam. The order against PWC was passed for not complying with the auditing standard, as per Section 11 of the SEBI Act and Prevention of Fraudulent and Unfair Trade Practices (UFTP).

❖ S.11 of SEBI Act - Authorizes SEBI to pass orders in favor of the investors.

Role of Bombay High Court:

Back in 2010, the Bombay High Court ruled that 'No discretion can be issued against PWC if there is only some omission and no proof of connivance and intent to fraud.'

According to SEBI, PWC showed complete negligence and carelessness while performing its practice of auditing. Following this, PWC moved the Securities Appellate Tribunal (SAT) challenging the order of SEBI.

Role of SAT:

PWC filed an appeal to the SAT questioning the legality and veracity of the impugned order of the SEBI.

On 9th September 2019, SAT decided to quash the order of the SEBI debaring the PWC firms as well as the two auditors from auditing the listed companies. The SEBI directions to the listed companies not to

⁶ Musaib Khan, "Satyam Case – Role of SEBI and SAT in the matter", *available at*:

<https://blog.ipleaders.in/indias-biggest-corporate-fraud-the-satyam-scam-and-the-role-of-sebi-and-sat/>



engage with any audit firms that are a part of PWC network has also been quashed.

Takeaways from the SAT Order:

- SAT had said that SEBI does not have the authority to decide upon the quality of audit standards and services. SEBI can only take remedial and preventive action, and the ban on PWC is neither.
- SEBI jurisdiction over the Chartered Accountants (CA) was upheld by the Bombay High Court.
- SEBI's allegation against PWC is not backed by evidence.
- Explanation of duty and responsibility of auditor - Auditors are Watchdogs and not Bloodhound.
- Auditor's duty is verification and not detection.

Under AAS 4, primary responsibility of prevention and detection of fraud and error rests with those charged with the governance and management of an entity.

- Subsequent strengthening of PWC internal quality practices and its acceptance by SEC/PCAOB in the US should be considered by SEBI.
- Monetary penalty was held justified - for that breach of duty and failure to maintain that standard of care.⁷

⁷ Vishal Jain, "SAT Order – PWC Satyam case", available at: <https://taxguru.in/chartered-accountant/sat-order-pwc-satyam-case.html#:~:text=On%209th%20September%2C%2>

ROLE OF AUDITORS AND COMPANIES ACT 2013:

S.245 of Companies Act 2013 gave a statutory recognition to Class Action suits by the shareholders.

S.241 further insured shareholders activism and provisions were made for any kind of mismanagement by the company, oppression of minority shareholders, etc.

- A Class Action suit is one where the shareholders of a company collectively institute a suit against the company.

While it was inserted in the 2013 Act, it was only notified in June 2016. Plaintiffs harmed by a common defender can hold him liable in all but a single suit. This licenses the individuals and the contributors to approach the NCLT if the organization acts in a way inconvenient to its investors.⁸

S.151 of Companies Act 2013 provides for election of small shareholder's directors and S.149 requires one-third of the Board to be independent directors - their duties, limitations, conditions are all clearly specified.

S.166 - Duties of Directors of a company to enhance corporate governance mechanisms.

- To enhance fairness in the accounting process; [as governed by Companies (Audit and Auditors) Rules, 2014]
- An individual auditor cannot serve the same listed company for more than one

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⁸ Swati Koul & Chahana Charles, "Critical Analysis of the Satyam Computers Scam: India's Biggest Accounting Fraud", available at: <https://lexforti.com/legal-news/satyam-computers/>



term of five years and an audit firm cannot do so for more than two terms of five years, i.e., 10 years.

S.141 of Companies Act 2013 - Only CA firms can be auditors and the person who signs the final accounts must necessarily be a chartered accountant.

➤ Auditing firm to necessarily have access to all the books of the company.

S.143 - Duty to disclose the frauds detected in the functioning of the company by the Auditor to the Board or the Central Government, depending upon the magnitude of the fraud⁹.

→ i.e., the duty of the auditor to report fraudulent acts noticed by them during the performance of their duties.

- An auditor can perform only audit services for the company, its holding and subsidiary companies. This is to ensure that there is no conflict of interest which may arise if the auditor performs other functions such as accounting and investment consultancy services for the same company.
- Majority of independent directors to be part of the audit committee as well as at least one in the remuneration committee.
- Remedy for initiating class action suits against the company and its auditors for damages has been provided U/S. 246 of Companies Act 2013.

SEBI'S NEW POLICY FOR ITS GATEKEEPERS:

The gatekeepers to the public securities markets as well as their independence are of utmost importance as they have to potential objectives;

1. To protect the investors economic interest; and
2. To prevent misconduct by the managers.

As the financial market has three major players: the manager, and auditor and the investors, SEBI had set up a new whistle blowing mechanism in place for the auditors and the other gatekeepers namely, the financial analysts and credit rating agencies, to report the cases of financial irregularities and other fraudulent transactions.

Unlike the 'informant mechanism' that is limited to cases of Insider trading, this proposed 'confidential mechanism' can help in all cases of financial frauds that are being reported at an early stage by the auditors, independent directors and others considered to be gatekeepers.

CONCLUSION:

While the unearthing of India's largest corporate fraud Satyam scam did bring in new reforms in the policies and amendments made to the law, greater responsibility is being placed on the auditors, independent directors, investment bankers, valuers and other such entities to ensure compliance to these new regulations and safeguard the interest of minority shareholders.

The quashing of the SEBI order by the SAT partially on the ban stating lack of

⁹Divyansh Saluja, "Reminiscences of Corporate Governance from Satyam Fraud", *available*

at: <https://taxguru.in/company-law/reminiscences-corporate-governance-satyam-fraud.html>



jurisdiction as it is only remedial and preventive in nature, shows the lacunae in the legal system and the regulations with regard to such financial scams.

Further SEBI faces challenges in procuring evidence and establishing links in financial frauds as the investigation takes much longer time, hence it is the moral responsibility of the financial gatekeepers to act up as the stringent regulations are more in letter than in spirit.

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