Examining Role of IL&FS Auditors

What is the issue?

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Union government's lame policy measures favor bigger audit firms with a large number of subsidiaries.

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What is overview IL&FS issue?

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- Infrastructure Leasing & Financial Services (IL&FS) is a Non-Banking Finance corporation (NBFS) which lends for infrastructural projects.
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- The infrastructure lender has a total consolidated debt of close to Rs 1 lakh crore, and it started to miss deadlines on its debt obligations beginning August 27, 2018.
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- It has already defaulted on around Rs 450 crore worth of inter-corporate deposits to Small Industries Development Bank of India (SIDBI).
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- The panic in the fixed income market due to the IL&FS default has led to a liquidity freeze, and fund managers say it is putting pressure on the equity markets too.
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- With IL&FS desperately looking for a bailout, state-owned insurance behemoth LIC came forward to help the company.
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What are the measures taken to address IL&FS issue?

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- The government has done well to tell the National Company Law Tribunal (NCLT) that it plans to reopen the accounts of IL&FS since it suspects

large auditor lapses.
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- The probe by the Serious Frauds Investigation Office (SFIO), the government said, indicated that the accounts were fraudulent.
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- The SFIO probe, and the reopening of accounts will also help find if there was siphoning off of funds in less than a month of taking over.
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- The Kotak panel had informed NCLT, the investments of IL&FS Financial Services in group arms was significantly in excess of RBI norms.
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- In a parallel probe, the CA institute (ICAI) has sent a formal notice to the partners of three audit firms to begin an investigation into their audits, so far no action has been proposed when it comes to IL&FS directors.
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What are the issues with role auditing agencies in this regard?

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- Given that the auditor fees paid by IL&FS rose from Rs.4.5 crore in FY15 to Rs.15.9 crore in FY17, before falling to Rs.13.7 crore in FY18, it is truly worrying that the auditors never flagged issues at IL&FS for all these years.
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- The IL&FS annual report for 2018, for instance, gives the company's net profits of Rs.584 crore for the year within the first few pages, but it takes till the 210th page to know that group incurred a net loss of Rs.1,869 crore that year.
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- And while the company's borrowings are Rs.15,935 crore, it is only in the consolidated balance sheet also in the annual report that one get to know the group debt is Rs.106,483 crore.
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- And before reporting this, the auditor firms report that there are 141 subsidiaries, 12 associates and 26 joint ventures whose accounts were audited by other firms and, in addition, it did not audit the financial statements of 18 subsidiaries, 6 associates and 17 joint ventures.
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- Surely if the auditor knew there were such a large number of subsidiaries and related entities where close to Rs.90,000 crore of debt was parked, it

needed to flag this.
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What weak policy measures drove this problem?

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- A large part of the problem stems from the fact that the Indian law allows too many layers of subsidiaries.
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- While ICAI can penalize the members who did the audit, it can take no action against the firms under whose banner they work.
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- IL&FS had 347 entities that were held via four levels of step-down subsidiaries and there were 142 entities at Level 4.
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- The modus operandi seems to have been to keep the parent accounts clean while keeping the debt in the subsidiaries.
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- Nor, so far, has the government agreed that one entity audit the accounts of the entire group, including subsidiaries.
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- Presumably this will be seen to be favoring the bigger audit firms as only they have the manpower to audit really big firms with a large number of subsidiaries.
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- In which case, chances are the first line of defense of the audit firms will be that they didn't audit the accounts of the subsidiaries and so cannot be held accountable for the gaps in those accounts.
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What lies ahead?

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- Some changes in the law are required mandatorily reporting some group-level financial ratios while giving individual company data.
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- Tough action is taken against auditors, rating agencies and the directors of firms, that there can be some hope that such blatant irregularities won't take place in the future.

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Source: Financial Express

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