

* **IN THE HIGH COURT OF DELHI AT NEW DELHI**

% *Judgment Reserved on : February 02, 2017*
Judgment Delivered on : February 03, 2017

+ **CHAT.A.REF 2/2013**

COUNCIL OF THE INSTITUTE OF CHARTERED
ACCOUNTANTS OF INDIA

....Petitioner

Represented by: Mr.Rakesh Agarwal, Advocate
with Mr.Pulkit Agarwal, Advocate

versus

CA G S JOHAR & ANR.

.....Respondents

Represented by: None

CORAM:

HON'BLE MR.JUSTICE PRADEEP NANDRAJOG

HON'BLE MR.JUSTICE YOGESH KHANNA

PRADEEP NANDRAJOG, J.

1. A complaint dated December 26, 2000 was received by the Council from the Assistant General Manager, State Bank of India, New Delhi against G.S.Jauhar & Co. of which the respondent was a partner alleging that acting on behalf of the partnership firm which was the Statutory Auditor of M/s.Pertech Computers Ltd. (hereinafter referred to as PCL), while carrying out the audit the respondent was guilty of various acts of commission and omission and thus action needs to be taken against the respondent for professional misconduct. Respondent admitted being incharge of the audit team.

2. Briefly put, the complaint was to the effect that various financial institutions and banks, including the complainant bank (acting in a consortium), sanctioned and granted various capital facilities from time to

time to PCL in respect of its business of marketing computers and software. That as per terms of the sanction of the capital it was incumbent upon PCL to ensure that drawings on the account were covered by the advance value of the stock hypothecated to the complainant bank. Various banks and financial institutions had also extended financial assistance to M/s.Altos India Ltd. (hereinafter referred to as AIL), a sister concern of PCL. In a special audit carried out of the stock etc. of AIL, glaring acts of commission and omission committed by AIL surface. That IDBI, a creditor of PCL circulated a background note to the effect that with effect from 1988-89 the increase in stock of PCL was much higher than the profits generated and similar was the position with AIL with effect from the year 1992-93. That the two companies had adopted a modus operandi, being, booking as sales of software reported developed by PCL was shown to third parties who would in turn show delivery to AIL as a purchaser and from AIL sales were shown to PCL. This loop was repeated many times. IDBI estimated the value of current assets generated through the said process to the tune of ₹362 crores being only paper entries, required to be written off. In these circumstances the consortium became suspicious and directed to carry out a special audit. M/s.G.Jai & Associates was assigned the job to carry out a special audit of the stock of PCL. Report submitted by the special auditor made startling revelations regarding financial irregularities by PCL; fraud and breach of trust by the Directors of PCL. Serious irregularities committed by the statutory auditors in discharge of their statutory duties were highlighted. Confronted with the special audit report Sh.Dadan Bhai, Chairman of PCL confessed that the accounts of PCL for the years in question did not correctly reflect the financial position of the company.

3. The complaint was forwarded to the respondent who submitted a

written statement of his defence on April 05, 2004, taking the stand that an auditor cannot be held responsible for preventing fraud by a company. The respondent also disputed the report submitted by M/s.G.Jai & Associates. The response was submitted for rejoinder to the complainant who filed the rejoinder on August 09, 2004. Respondent was handed over the rejoinder and he submitted his comments thereto on November 29, 2004. Prima-facie opinion being formed that the respondent was guilty of professional and other misconduct, in May 2005 the matter was referred to the Disciplinary Committee.

4. The Disciplinary Committee submitted a report on February 03, 2010. The findings returned are that the main charge against PCL were arising out of the allegation that there were overstatement/under-statement of the stocks, debtors, inflation of sales and manipulation of accounts and that the auditor failed to comment on the same, which in turn established that the auditor was in connivance with the management of the company to defraud the bank and the public. That the respondent was the statutory auditor of PCL since inception and lastly audited the balance sheet for the year ending December 31, 1996. Further, the respondent was the statutory auditor of AIL for the years 1985-86 to 1991-92. The Committee noted that the complainant failed to produce copies of the monthly stock statement and debtor's statements submitted to the complainant by PCL. Since PCL was under liquidation, the complainant also failed to obtain copies of the ledger's account, cash book etc. from the official liquidator. The committee also noted that as per the terms and conditions on which the working capital facility was sanctioned by the complainant to PCL, the condition of PCL submitting stock statement at the close of each fortnight, were not examined by the officers of the complainant. Respondent's stand that he was not to look

into the statements and his role was to certify the balance sheet only was noted by the Committee.

5. The Committee noted the following findings given by the special auditor in regard to the stock:-

“2. Stocks

2.1 Analysis/review of the sales to certain parties accounts (whose accounts are clubbed under the supplier's sub ledger) revealed that SWT sales have been, inter alia, made to the certain selected parties during the year 01.01.1996 to 31.12.1996.

2.2a) Certain amounts have been shown as paid on behalf of AIL to certain selected SWT debtors through State Bank of Bikaner and Jaipur which may be taken by the Banks for the verification with the bank statements.

2.2b) Details of amounts debited to AIL's accounts with corresponding credit entries appearing in the selected SWT debtors accounts.

2.2c) Amounts debited to AIL's account as purchase returns during the period 01.01.1996 to 31.12.1996 amounted to ₹7403 lacs.

4.3.12 Valuation of Stocks

PCL uses weighted average cost (for the main group) for valuing the various stocks. This cost is arrived by determining the weighted average cost of opening stock plus purchases during the year. Moreover, the weighted average cost as determined at the end of year as per the audited accounts is applied throughout the year. For instance, in the current stock statements (January to June 1997), the weighted average cost as determined for the year ended 31.12.1996 is being applied. In the present days of fall in computer prices such a method results in overstatement of stocks. In addition, such a method does not provide for any change in the product mix subsequent to the date/period for

which the weighted average cost was worked out.”

6. The committee noted that the management of the company had admitted that the books of the CL were manipulated and had submitted a rework financial statement.

7. The Committee formed a view that being the auditor of PCL since inception, the respondent should have had an understanding of the design of the accountant and the internal control system of the company. The committee highlighted that balance sheets of PCL, with reference to the notes to the accounts, showed the method of valuation of Inventory as Weighted Average Cost Method, whereas in Schedule 7 – Inventories, it was stated : *‘valued at cost or market value whichever is less’*. The committee opined that both disclosures were contrary to each other. The committee further noted that at the time of hearing the stand taken by the respondent was that PCL was a trading company and followed Weighted Average Cost Method, which was in contravention of Accounting Standard-2 (AS-2), which specifically laid down the method of valuation of inventory as cost or market value whichever is less. But the committee held that it was not taking cognizance of the same since the method of valuation of inventory, albeit wrong, was consistently followed by the company. However the committee highlighted that classification of the inventory ought to have been disclosed in the notes to the accounts. The committee further noted that during the period January 01, 1996 to December 31, 1996 huge payments were made by PCL on behalf of AIL but no disclosure of the same was made by the auditor in the report as contemplated by law. Further, there were suspicious adjustment entries between AIL and PCL which ought to have raised a doubt about the genuineness of the transactions and ought to have been detected and

reported by the respondent. Regarding liability of the auditor, in paras 26 to 35 of the report the committee, with reference to the evidence before it the stand taken by the parties, the Committee opined as under:-

“26. The Committee perused the financial statements of the years under question, the working results of the Company and the background note circulated by IDBI and observed that a major portion of the Company’s profit flowed from increase in stock. Further, in the later years, namely, from 1988-89 onwards that the increase in stock was always higher than the net profit.

27. The modus operandi which was adopted by PCL and AIL was booking as sales of a software reportedly developed by PCL to an outsider party which in turn would be passed on to AIL as purchaser which again would be supplied to PCL as sales. In this process, this loop getting repeated many times but there was no cash flow while the sales and stock/receivables kept on increasing. However, the Company was required to pay the difference in the process booked by PCL to the party and the party to AIL. It was also observed that the dividends were not paid out of the generated funds but out the borrowed funds. Further, it was also noticed that the said process continued till the financial year ending 31st March, 1996.

28. In the aforesaid context, the Committee also noted that as per Section 227(1A)(b) of the Companies Act, 1956 the Auditor shall inquire:

“(b) whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company.”

29. However, it is apparently clear that the respondent as Statutory Auditors of the Company for all these years was unable to assess the modus operandi of these transactions which were in the nature of book entry only even though the same was a statutory requirement within the meaning of Section 227(1A)(b) of the Companies Act, 1956, which makes it incumbent on the Auditor to enquire whether such type of

transactions have in fact taken place and if so, whether they are prejudicial to the interest of the Company since the increase in sales, sundry debtors, stock over all these years were not in existence in real terms and gave a rosy picture about the affairs of the Company which were actually prejudicial to the interest of the Company. The respondent as the Auditor of the Company failed to check and report the same in his audit reports for all these years under question. Moreover, on perusal of the audit reports for all these years, it has been observed that the respondent also did not comments about the internal control procedures of the Company. The respondent did not apply the necessary checks which is expected of an auditor in the circumstances which were prevalent at that time and did not carry out the comprehensive checks about the actual funds having been received by the Company and about the profits whether they were actually in existence or not.

30. The Committee further noted that as per the requirement of AAS-4. The Auditors' Responsibility to consider fraud and error in an audit of financial statement:

"Documentation

49. The auditor should document fraud risk factors identified as being present during the auditor's assessment process and document the auditor's response to any such factors. If during the performance of the audit, fraud risk factors are identified that cause the auditor to believe that additional audit procedures are necessary, the auditor should document the presence of such risk factors and the auditor's response to them.

50. The auditor must document matters which are important in providing evidence to support the audit opinion, and the working papers must include the auditor's reasoning on all significant matters which require the auditor's judgment, together with the auditor's conclusion thereon. Because of the importance of fraud risk factors in the assessment of the inherent or control risk of material misstatement, the auditor documents fraud risk factors

identified and the response considered appropriate by the auditor.”

31. Further, as per AAS-3, Documentation:

“1. Auditing and Assurance Standard (AAS)1, “Basic Principles Governing an Audit” (Paragraph 11), states, “The auditor should document matters which are important in providing evidence that the audit was carried out in accordance with the basic principles.” The purpose of this Standard is to amplify the basic principles outlined above.

2. Documentation, for purposes of this Standard, refers to the working papers prepared or obtained by the auditor and retained by him, in connection with the performance of his audit.

3. Working papers:”

.. aid in the planning and performance of the audit;

*.. aid in the supervision and review of the audit work;
and*

.. provide evidence of the audit work performed to support the auditor’s opinion.”

32. In view of above, it is very clear that the auditors are required to maintain the working papers and document the same for his reference purposes whereas in this particular matter when the Committee insisted the respondent to produce the working papers so as to show whether he had followed the necessary checks while carrying out his audit, the respondent submitted before the Committee that he was not in possession of working papers any more since he has surrendered the Certificate of Practice in the year 2003. The respondent on the other hand insisted upon the Committee to call for the books of accounts and other papers of the Company from the Complainant. The Committee had given necessary directions to the Complainant to procure these documents from the Official Liquidator of the Company

which they were not able to produce even after adjourning the matter number of times. The Committee felt that even in the absence of these documents, there were sufficient papers on record to show that the respondent had not been able to diligently carry out his role as the auditor of the Company for all the years under question.

33. The Committee further noted that the huge limits were sanctioned to the Company based on the stock and debtors statements of the Company. The respondent being the Statutory Auditor of the Company for all these years did not find it fit and necessary to call for these stocks and debtors statements so as to form an opinion that the same were actually reflective of the true position of the Company.

34. Further, the information that PCL and AIL was in liquidation due to fudging of Books of Accounts were in public domain and the Respondent as the Statutory Auditor ought to have retained his working papers in those circumstances. Moreover, the Regulation 14 of the Chartered Accountants Regulations, 1988 specify a period of 10 years or more for entertaining a complaint or information but in the said matter the Committee observed that this complaint is not barred as per the Chartered Accountants Regulations, 1988.

35. The Committee felt that an auditor needs to plan and perform this audit with an attitude and professional skepticism so as to identify and properly evaluate the matters that increase the risk of material misstatement in the financial statements, the circumstances that make the auditor suspect that the financial statements are materially misstated. The Committee noted that from the circumstances which were in existence at the time of audit and the manner in which the loop of transactions had been carried out by the Company along with the other companies revealed that the Respondent ought to have applied his professional skepticism and should not have accepted these transactions as genuine. Moreover, in view of the Committee, the manner in which the transactions were booked in the books of accounts of the Company ought to have raised an alarm that the financial

statements were suspected to have material misstatements which as a prudent auditor, the respondent did not try to assess and accordingly failed in his duties to carry out the audit in a diligent manner and in other words helped the management to defraud the bank and public at large of the funds which they had invested in the Company.”

8. Suffice it to highlight that in paras 26 and 27 of the report the Committee highlighted the modus operandi adopted by PCL and AIL to form a loop with no cash flow coming in, but sales, stocks and receivables increases. The obligation of the auditor concerning transactions which are merely book entries was highlighted i.e. the duty of the auditor to enquire whether the transactions were prejudicial to the interest of the company being not discharged by the auditors. The Committee also highlighted that as an auditor it was the obligation of the respondent to comment about the internal control procedures of the company. With reference to AAS-3 and AAS-4, the Committee further brought out the obligations of the auditor to be discharged in the course of the audit.

9. The Committee has also highlighted the duties of the auditor to maintain the working papers and documents and noted that in spite of repeatedly directed to do so, the respondent did not produce the papers and took the plea that since the year 2003 he had surrendered the certificate of practice, therefore he was not keeping the past record.

10. The least which was expected from the respondent was to have filed a counter affidavit dealing with aforesaid indictments.

11. The respondent has chosen not to file any counter affidavit.

12. The report of the Disciplinary Committee is based on the accounting standards to be followed and breach thereof. Having not filed any response to the report of the Disciplinary Committee, and finding the

report to be suffering from no infirmity, as did the Council accept the same, so do we. Indeed, the respondent is guilty of committing professional misconduct falling within clauses 5, 6, 7 and 8 of Part 1 of the 2nd Schedule to the Chartered Accountants Act, 1949.

13. Keeping in view the scam which has taken place and the seriousness of the indictment of the respondent we accept the recommendation of the Council and levy the penalty of removing the name of the respondent from the register of members of the Institute of Chartered Accountants for a period of 5 years.

14. The reference is disposed of.

(PRADEEP NANDRAJOG)
JUDGE

(YOGESH KHANNA)
JUDGE

FEBRUARY 03, 2017
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