

Role of Auditing in Preventing Corporate Fraud

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Abstract

In light of India's current legislative and corporate governance framework, this article explores the critical role auditing plays in combating corporate fraud. The paper emphasizes the importance of auditing in guaranteeing accuracy, transparency, and compliance in financial reporting, starting with the conceptual underpinnings of auditing as an independent verification method. The article describes the Comptroller and Auditor General's (CAG) constitutional mandate under Articles 148–151 of the Indian Constitution as well as important clauses from the Companies Act, 2013, which together provide the legal foundation for audit supervision. It also examines how auditing improves internal controls, finds financial anomalies, encourages accountability, and serves as a powerful disincentive to unethical behavior.

Auditing:

The word Audit is derived from Latin word “Audire” which means ‘to hear’. **Auditing** is the systematic examination and verification of a company's financial and operational records by a qualified professional, typically an auditor. The process aims to ensure the accuracy, completeness, and compliance of financial statements and operations with applicable standards and regulations. Auditing helps to enhance the credibility of financial reports, providing assurance to stakeholders such as investors, creditors, and regulators that the statements present a true and fair view of the company's financial position and performance.

Therefore we can say that, Accounting is the process of creating financial records, while auditing is the independent process of verifying those records for accuracy and compliance.

Legal Provisions related to Auditing in India:

1) Constitution of India:

The **Comptroller and Auditor General (CAG) of India** is a **constitutional authority** established under **Article 148** of the Indian Constitution. The CAG serves as the **supreme audit institution** of the country and acts as the **guardian of the public purse**. The Constitution ensures the CAG's **independence** by providing security of tenure, fixed service conditions, and protection against arbitrary removal, which can only be done in the same manner as a judge of the Supreme Court.

Under **Articles 149 to 151**, the CAG is responsible for auditing the accounts of the Union and State Governments, government-owned corporations, and authorities substantially financed from government funds. The CAG submits audit reports to the President or the Governor, who then place them before the Parliament or State Legislature.

Thus, the CAG plays a vital role in promoting **accountability, transparency, and financial discipline** within the government machinery.

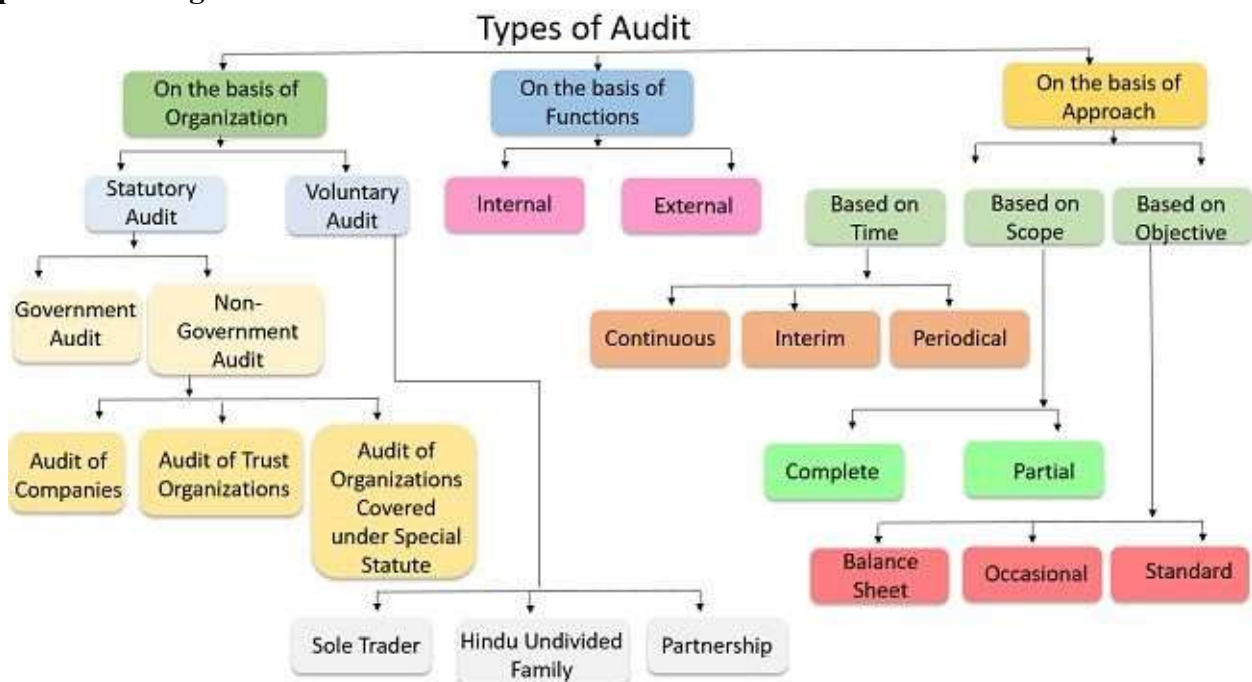
2) The Companies Act 2013:

The **Companies Act, 2013** contains several provisions that govern the appointment, duties, powers, and responsibilities of auditors to ensure transparency and accuracy in corporate financial reporting.

- **Sections 139–148** of the Act deal specifically with audit and auditors.

- **Section 139** provides for the appointment of auditors, including tenure, rotation of auditors for certain companies, and procedures for reappointment or removal.
- **Section 140** lays down the removal, resignation, and special notices related to auditors.
- **Section 141** sets the eligibility and qualifications of auditors, along with disqualifications to ensure independence.
- **Section 142** deals with remuneration of auditors, fixed by shareholders or the Board depending on the type of auditor.
- **Sections 143 and 144** specify the powers and duties of auditors, including access to books, reporting requirements, and restrictions on non-audit services to avoid conflict of interest.
- **Section 145** mandates signing of the auditor’s report.
- **Section 146** requires auditors to attend general meetings where their reports are discussed.
- **Section 147** provides penalties for auditors and companies for non-compliance.
- **Section 148** relates to cost audit, making it compulsory for certain classes of companies as prescribed.

Types of Auditing:



Role of Auditing in Preventing Corporate Fraud:

In order to improve corporate governance and lower the risk of fraud in an organization, auditing is essential. The following are some of the ways it helps avoid fraud:

1. Increasing Internal Controls

Internal control systems' efficacy and sufficiency are assessed by auditors. They assist management in closing gaps that could be used for fraud by detecting control flaws, such as bad permission procedures, inadequate segregation of roles, or inadequate paperwork.

2. Early Identification of Abnormalities

Auditors can identify anomalous entries, inexplicable variations, or suspicious activity by closely examining transactions, reconciliations, and financial patterns. Early discovery keeps minor abnormalities from growing into massive business frauds.

3. Ensuring Accountability and Transparency

Transparency in financial reporting is enforced by auditors. The likelihood of intentional misstatements, account manipulation, or liability concealment is greatly decreased when financial statements are carefully examined and validated.

4. Encouraging a Deterrent Impact

Employees and management who might consider unethical behavior are strongly discouraged by the certainty that internal procedures and financial records will be objectively examined. A culture of caution and compliance is encouraged by the presence of auditors.

5. Confirmation of Adherence to Rules and Regulations

Auditors make ensuring that corporate governance guidelines, accounting standards, and legal requirements are being followed. Non-compliances frequently serve as warning signs for fraudulent activity; by reporting these deviations, auditors can stop fraud from getting worse.

6. Identification of Fraud Risk Areas

As part of risk-based auditing, auditors assess areas most vulnerable to fraud—such as cash handling, procurement, related-party transactions, inventory management, and revenue recognition. Addressing these risk areas reduces opportunities for fraud.

7. Enhancing Corporate Governance

Auditors report to the Board and Audit Committee, ensuring that top management is held accountable. Their observations help improve governance practices, check misuse of power, and curb management-level fraud.

8. Verification of Assets and Liabilities

Physical verification of assets and scrutiny of liabilities prevents misappropriation of assets, fictitious entries, or manipulation of financial realities—common techniques in corporate fraud.

9. Encouraging Ethical Business Practices

By setting expectations for fairness, accuracy, and regulatory adherence, auditing fosters an ethical culture that discourages dishonest behaviour within the organisation.

IL&FS Fraud Case: 2018

Infrastructure Leasing and Financial Services was an NBC (Non Banking Company) that was a big name in India's financial system— managing highways, real estate and infrastructure projects with 350+ subsidiaries and AAA rating, it was considered too big to fail.

But in September 2018, the illusion shattered as IL&FS defaulted on more than Rs. 90,000 crore of debt. This triggered the entire financial system in India.

Investigations revealed reckless lending, corporate mismanagement and accounting irregularities. The company borrowed heavily to fund long term infrastructure projects, but failed to generate enough cash flow, creating a debt trap.

Further, executives allegedly concealed the true picture through creative accounting, mutual funds, insurance companies and banks heavily exposed to IL&FS faced liquidity crunch resulting in a chain reaction.

The Indian Government intervened by taking control of IL&FS, replacing its board and launching probes against former Directors.

The scandal forced regulators to overhaul rules governing the Non Banking Financial Companies, tightening oversight on leverage and risk disclosures.



This was a wake up call for the Indian financial market as even the big institutions can fail and collapse if left unchecked, thus highlighting the role of proper audit mechanism.