

INTRODUCTION TO AUDIT REPORTS



CA Amit Chheda

Email : amit@dalaldoctor.com

Chapter 10 of the Companies Act 2013 (the Act), i.e. from Section 139 to Section 148, governs audit and auditors of the Company. Section 143 of the Act, specifically deals with the reporting framework of the auditor. Section 143 has in all 15 sub-sections.

Subsection 1 of section 143 deals with broader principles which an auditor shall enquire about and his certain basic rights. Subsection 2 casts a duty on the auditors to report, whether the accounts reflect the true and fair view, whereas subsection 3 requires an auditor to report on certain specific points as listed in the said subsection.

Further, Subsection 11 gives power to the Central Government to prescribe additional reporting requirements. In exercise of the powers, the Central Government notified Companies (Auditor's Report) Order, 2020 on 25 February 2020 (CARO 2020) after consultation with the National Financial Reporting Authority (NAFRA).

Historically, the Companies Act has always had such a clause giving power to the Central Government to direct the auditors to report on a certain aspect of the Company. In the erstwhile Act of 1956, the same was named as MAOCARO, which now has been renamed as CARO. CARO 2020 has been introduced with certain additional clauses and removal of certain redundant clauses. CARO report has also been through various amendments over the period including in the year 2003, 2015, 2016.

CARO 2020 was originally planned to be implemented for the statutory audits commencing on or after April 1, 2020 (i.e. for the financial year 2019-20 onward). However, considering, the prevailing pandemic situation, MCA vide order dated 17.12.2020, extended the applicability date by one more year, i.e. from the financial years commencing on or after the 1st April 2021. Accordingly, CARO, 2020 will be applicable from FY 2021-22.

Applicability for quarterly financial statements for the year 2021-22: CARO is applicable to the financial year commencing after the specified date and not the quarterly financial statements.

Applicability on financial years ending other than 31st March: For the first time CARO 2020 will be applicable for the full financial commencing on or after 1st April 2021. Accordingly, for a company, if the financial year is ending on a date other than 31st March, the applicability will be for the financial year 2022-23. For eg, if Company is following December as the year ending, then for such Companies, CARO will apply from the Financial Year 01st January 2022 to 31st December 2022.

There are certain clauses in the revised CARO 2020, which are very subjective and require professional judgment. For eg, the revised CARO requires an auditor to assess whether any amount disclosed as income in the tax assessment is properly recorded in the books of account. Whether income is recoded properly or not will always be subjective. Further, there can be cases, where accounting any transaction basis merely addition in the assessment may not be feasible. For instance, income disclosed for peace of mind and if such income is accounted in books of accounts, will lead to overstating the profit, without actual substance of income. An auditor's judgement will be key to such adjustments.

There are certain clauses in the new CARO, which have been reintroduced from earlier versions of CARO / MAOCARO. Reporting on the adequacy of the internal audit system (wherever applicable) has been reintroduced. Again there will be subjectivity as to how one interprets "commensurate". Internal Audit may seem commensurate to one auditor, may not be to another auditor.

The new CARO requires an auditor to assess the reason for the resignation of the previous auditor and should take into consideration the issues, objections or concerns raised by the outgoing auditors. Accordingly, it would be very important that the No-Objection communication with the previous auditor covers the reason of resignation and the same is adequately addressed in the audit report and the financial statements.

We will deal with all the clauses in the subsequent articles. For ease of understanding, these clauses has been grouped as Balance Sheet related clauses, Profit and Loss related clauses, other general administrative and compliance clauses. I would like to thank the committee for the timely issue on the subject.

Applicability of CARO:

CARO 2020 is applicable to all Companies, except the following:

1. Following Companies which are Governed by separate:
 - Banking Companies.
 - insurance company
2. Section 8 Companies.
3. One Person Companies.
4. Small Companies.
5. Companies not affecting larger section of the society.

The first 3 options, being fairly simple, may not need further discussion. We will discuss the exemptions available to small companies and companies not affecting larger section of society.

Small Companies:

With effect from 1st April 2021, the definition of small companies has changed drastically and thus covering many Companies in the revised definition. As per the new threshold limits, companies with a paid-up capital of INR 2 crore or less, and turnover of INR 20 crore or less come will be considered to be small companies.

Below is the comparison for new limits:

Particulars	Old Definition	Revised Definition
Paid-up share capital	50 lakhs	2 crores
Turnover	2 crores	20 crores

With this updated definition, it is believed that approx. 80% to 85% of the Companies will be out of CARO Coverage.

One should note that the following companies shall not be regarded as a small company:

- A public Company (irrespective of listed or unlisted)
- A holding company or subsidiary companies (including a private limited company). A Company may have a subsidiary which is non-operational or with very limited operation, in such case CARO will be applicable to both the holding and subsidiary company.
- Section 8 Companies.
- a company or body corporate governed by any special Act such as banking companies, insurance companies etc.

Since the amendment is effective from 1st April 2021, there will be no change in the filing requirement for the company for the year March 2021 and accordingly, in my view for the year 2020-21, older limits should apply.

Companies not affecting larger section of society.

A Company complying with the following conditions are exempt from reporting:

- a. It should be a private limited company. Accordingly, public companies, whether listed or unlisted are not exempt from CARO. CARO will be applicable to a public company irrespective of its size, its turnover and net-worth.
- b. The Company should not be a subsidiary or holding company of a **public** company. One should note that the restriction is on subsidiary / holding relation with a public company and not with a private limited company. Holding or subsidiary company of a private limited company can continue to claim an exemption under this clause subject to compliance with other conditions.
- c. As on the balance sheet date, the paid-up capital + reserves and surplus should not be more than 1 crore rupees.
 - Paid-up capital will here include preference share capital and shall exclude Share application money pending allotment.
 - Reserve and Surplus here shall include Revenue as well as capital reserves. Revaluation reserve shall also be included and carried forward balance of losses, if any, shall be deducted. In case Companies following IndAS, equity component of compound financial instrument, debt/equity instrument through other comprehensive income (OCI), the effective portion of cash flow hedges, exchange difference on translating the financial statement and other items of OCI are not considered to be part of reserve & surplus.

- d. Total borrowings from any bank or financial institution at any point of time during the financial year does not exceed 1 crore. One should note:
- The limit would apply in the aggregate to all borrowings and not with reference to each bank or financial institution.
 - Actual borrowing by the Company shall be considered and not the sanctioned limits. A Company that has the sanctioned limits but does not utilise it, will not be covered. Non-fund based credit facilities, to the extent such facilities have devolved and have been converted into fund-based credit facilities, should only be considered as outstanding borrowings.
 - Bank guarantees: guarantee(s) invoked and encashed shall only be considered as borrowing.
 - Accrued and due, interest shall also be considered as borrowing.
 - Unsecured borrowing from the bank or financial institution will also form part of borrowing. However, unsecured borrowings from members of the Company or its directors shall not be considered.
 - Borrowing from Government (Central or state) shall not be considered. Accordingly, subsidies from the government to be repaid over the years shall not form part of borrowing.
 - It has been clarified that the above limit shall be applied throughout the year and not at the beginning or end of the financial year. Accordingly, even if borrowing from the financial institution exceeds 1 crore for just one day, CARO will be applicable.
- e. Total revenue does not exceed 10 crores. Turnover shall mean, the aggregate of sales effected by the Company.
- Sales shall not include the sale of capital assets.
 - in case of commission agents, revenue shall mean commission revenue and not the total value of sales affected by the agents.
 - Taxes collected separately, trade discounts shall be excluded.
 - Sales return (irrespective of year of actual sale) shall also not form part of sales.

It may also be noted that in case a company is covered under the definition of a small company, it will remain exempted from the applicability of the Order even if exceeds the limits specified above.

With the revision of the definition of a small company, it is believed that exemption under point (e) will be almost redundant. Majority of exemption will be covered under the definition of Small Companies as against exemption in point (e).

Companies covered under CARO

Few examples of CARO being applicable:

- Foreign Companies.
- Project / Liaison Offices.
- Branches of Foreign Companies.

Other Points of Consideration:

Applicability on Government Audits:

CARO Report applies to the government audits too, irrespective of the directions given by the Comptroller and Auditor General of India (CAG) under section 143(5) of the Act. CARO Report will continue to form part of the annual report to the members of the Company and the replies to the questionnaires issued by the CAG will continue and will have to be answered.

Applicability to the Consolidated Financial Statements

CARO does not apply to the consolidated financial statements. However, clause (xxi) of the Report requires an auditor to comment on:

“whether there have been any qualifications or adverse remarks by the respective auditors in the Companies (Auditor's Report) Order (CARO) reports of the companies included in the consolidated financial statements, if yes, indicate details of the companies and the paragraph numbers of the CARO report containing the qualifications or adverse remarks.” Accordingly, the auditor is required to give a CARO report on the consolidated financial statements with respect to clause (xxi) of the Order only and is not expected to report on the rest of the clauses.

Materiality

While reporting on matters specified in the CARO, the auditor should consider the materiality. For example, while reporting on the repayment schedule of various loans granted by the company, the auditor examines the loan documentation of all large loans and conducts a test check, keeping in mind materiality.

Reporting

Where an auditor is unable to express any opinion on any clause, he is required to indicate in his report such a fact, together with the reasons as to why he is unable to express any opinion. The auditor is also required to give reasons for any unfavourable or qualified answer.

In case CARO is not applicable to the Company, it is advisable that the auditor's report include a statement giving an explanation that the order is not applicable to the Company. We as a practice also provide the reason. Similarly, in case any particular clause of the report is not applicable to the Company, it is advisable that the report brings out the relevant fact of non-applicability.

Management explanation on any unfavourable comment, need not be included by the auditor, unless where the auditor feels such inclusion is necessary. It is advisable to include management explanation in case the comment makes the reporting more meaningful and complete or the comment explains the fact that despite unfavourable comments, the true and fair view of the financial statements is not vitiated.

If any of the comments on matters specified in the Order are qualified or unfavourable, the auditor should consider whether his comments have a bearing on the true and fair view presented by the financial statements and, therefore, need to modify the audit report.

Section 227(3)(e) of the erstwhile Companies Act 1956, required an auditor to highlight the observation / unfavourable comment as Bold or italics. Similar provision is not included in section 143 of the Companies Act 2013. Accordingly, it is no more required to highlight the qualification separately.

Clarification on observation by the Board:

The board of directors shall be bound to give in its Director's report, all the information and explanations regarding reservation, qualification, adverse remark or disclaimer in the auditor's report. It is possible that, on the same facts, there may be a genuine difference of opinion between the auditor and the Directors. In such a case, each of them is entitled to hold his or their view. Therefore, the expression of a different opinion in the Board's report should not be regarded as any reflection on the opinion expressed by the auditor.

Subsequent articles will discuss, each clause of CARO 2020 in detail. We wish happy learning to all the readers.

