OTHER MISC. CLAUSES

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On 25th February, 2020, MCA (Ministry of Corporate Affairs), in consultation with the NFRA (National Financial Reporting Authority) and by virtue of Section 143(11) of Companies Act, 2013 (Companies Act), has issued Companies (Auditor's Report) Order, 2020 (CARO, 2020) which supersedes Companies (Auditor's Report) Order, 2016 (CARO, 2016).

The legacy of such reporting by auditors dates back to 1988 when it first started with reporting on about 24 clauses under the Manufacturing and Other Companies (Auditors Report) Order, 1988. However, with the passage of time, such reporting has seen many amendments; the reporting was reduced to 12 clauses in 2015 but then increased to 16 in 2016. With the changing environment, increasing corporate scams and misstatements in financial reporting by corporates, the authorities felt the need for the auditors of companies to provide greater insight and information to the stakeholders and users on specific matters relating to financial statements and business, which has given rise to CARO 2020. The order now requires auditors to report on various matters contained in 21 clauses and 38 sub-clauses.

The said order is applicable for reporting on financial statements of companies whose financial year commences on or after 1st April 2021.

Below are the brief summary for few clauses which highlight requirements of few newly inserted reporting requirement in this Order:

Paragraph 3(xiv)

(a) Whether the company has an internal audit system commensurate with the size and nature of its business;

(b) whether the reports of the Internal Auditors for the period under audit were considered by the statutory auditor;

- The clause requires a comment on internal audit system- where such system commensurate with the size and nature of company's business
- Applicability – As per section 138 of the Companies Act, 2013, internal audit is applicable on listed companies, unlisted public companies (with PUSC of INR 50 cr or turnover of INR 200 or outstanding borrowings exceeding INR 100 cr), or private companies (with turnover of INR 200 cr or outstanding borrowings exceeding INR 100 cr).

- Some of the factors which needs to be considered while evaluating the design of internal controls functions :-
    - The size of the internal audit team
    - Qualifications of internal auditors
    - Reporting responsibilities of an internal auditor
    - Involvement of audit committee
    - Scope of internal audit and extent of coverage
    - Assessment and remedial actions taken on the impact of the controls deficiencies, if any pointed by internal auditors.
    - The Guidance note requires management to consider internal audit observations that has financial impact
    - Evidence of evaluating the reports of the internal auditors and conclusions thereon

Paragraph 3 (xvii)

Whether the Company has incurred cash losses in the financial year and in the immediately preceding financial year, if so, state the amount of cash losses;

- The term cash losses in not defined in the 2013 Act/Ind AS/AS
- Companies following Ind AS, profit and loss to be considered excluding Other Comprehensive Income (OCI) - however consider realized cash profits or losses recognized in OCI
- Net Profit/Losses should be adjusted for non-cash transaction such as depreciation and amortization to compute cash losses.
- Net Profit/Loss would also require adjustments for
    - Deferred taxes
    - Foreign exchange loss/gain
    - Fair value changes
- It may not be appropriate to consider cash flow from operating activities from cash flow statement for the clause
- The amount of cash loss to be adjusted for qualification in audit report to the extent qualified
- in case of restatement in the financial statement , consider restated profits.

Paragraph 3 (xviii)

Whether there has been any resignation of the statutory auditors during the year, if so, whether the auditor has taken into consideration the issues, objections or concerns raised by the outgoing auditors

- the clause is applicable in case of resignation of auditors
- consider the reasons for resignation of order

- the incoming auditor would consider the potential impact of the resignation by the outgoing auditor on audit strategy and reporting
- management must provide
  - Letter of resignation of predecessor auditor and Form ADT 3
  - Minutes of board meeting
  - Audit committee presentation by predecessor auditors

Paragraph 3 (xix)

On the basis of the financial ratios, ageing and expected dates of realisation of financial assets and payment of financial liabilities, other information accompanying the financial statements, the auditor's knowledge of the Board of Directors and management plans, whether the auditor is of the opinion that no material uncertainty exists as on the date of the audit report that company is capable of meeting its liabilities existing at the date of balance sheet as and when they fall due within a period of one year from the balance sheet date;

- The clause requires reporting on company's ability to meet the liabilities falling due within one year
- Auditor to consider the paragraph on material uncertainty or key audit matters on going concern
- The test of existence of material uncertainty to be performed as on the date of audit report for the position of liabilities existing as at the date of balance sheet
- Reporting under this clause not exactly the same as assessing going concern assumption
- Evaluate all liabilities and status of subsequent payments, interim financial information after the balance sheet date, minutes of audit committee and board meeting held after the balance sheet date
- Consider financial ratios e.g. liquidity ratio (current ratio, acid ratio, cash ratio) efficiency ratio (asset turnaround ratio, inventory turnaround ratio , accounts receivable turnaround ratio)

Paragraph 3(xxi)

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 the details of the companies and the paragraph numbers of the CARO report containing the qualifications or adverse remarks.

- Reporting under this clause is only required for those entities included in the consolidated financial statement to whom CARO 2020 is applicable
- CARO report is to be included as separate annexure in audit report to consolidated financial statements
- Assessments of responses by component auditors as 'qualification/adverse remark required application of professional judgment
- Qualification/adverse remark gives parent company's standalone CARO report are also required to be included

- Every qualification/adverse remark made by the individual component should be included
- In case of audit report of the components has not yet issued by its auditor, then the principal auditor would include the fact in his/her report

Conclusion:

While the intent of the government seems to put a strict check on several crucial transactions entered into by the company which has a close nexus with the solvency/ financial risks existing in the company, the additional reporting requirements would require additional details from the management and thus it is very important that an auditor should have a dialogue with the management immediately for the latter to gear up. It is also important for the auditor to understand the process followed by the management for collection and processing of the required information and its control environment which will give him comfort while complying with the reporting requirements. Lastly, it is important for the auditor to take suitable management representations wherever accuracy and completeness of information provided by the management cannot be confirmed by the auditor to safeguard his position. The auditor would have to factor in additional efforts for reporting and the documentation which will have to be robust and fool-proof for future reference and as a safeguard against the enhanced reporting responsibility.