

## PRACTICAL ISSUES IN REVISED CARO 2020 REPORT



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### Background

The Companies (Auditor's Report) Order (hereinafter 'CARO'), 2020 Report has been applicable since the FY 2021-22. Thus making this the second year running for the applicability of the CARO, 2020 provisions. Prior to this the auditors, where applicable, were required to issue the report in accordance with the Companies (Auditor's Report) Order, 2016.

The CARO, 2020 Report has 21 clauses and these can be further divided into 47 subclauses. The CARO 2020 report has 7 newly added clauses and another 7 modified clauses when compared with the 2016 reporting requirements. The changes to the reporting requirements are mainly designed to address - Diversion of Funds, Early signs on Financial health, Security and Ownership of assets, Corporate Governance.

Upon perusal of the new reporting requirements, one cannot fail to observe how the structure of the CARO report has transformed over the years. Earlier the report was largely a statement of facts. However, in the present times, the report requires the auditor to provide an opinion on a lot more instances. This does not in any case mean that the auditor is required to carry out an investigation into the various areas, the auditor is merely expected to give specific information on certain aspects of his work.

In this piece we examine the practical issues and challenges in the revised CARO 2020 report with specific emphasis on some newly introduced and modified clauses including published accounts.

### Analysis of Critical Clauses

#### *Clause 3(i)(a)(B) - Intangible Assets*

This sub clause is newly introduced and requires the auditor's comments on whether the company is maintaining proper records showing full particulars of Intangible assets. The points for consideration under this clause are as follows:

- i. Although 'proper records' are not defined, they pertain to the quantitative details of the asset along with the asset's Description and Location. Reporting will be based on the audit evidence similar in nature to that of tangible assets.
- ii. There have been instances that the auditee has not maintained records for old intangible assets. The auditor may state this fact when reporting under this clause.
- iii. There have also been instances identified where the auditor has failed to report completely on whether proper records of intangible assets are maintained. The amount of intangible assets in this case was a small fraction of PPE and CWIP. Auditors must be aware of the fact that reporting under this clause is required irrespective of the materiality of the Intangible asset.

#### *Clause 3(i)(c) - Title Deeds*

This clause requires the auditor to comment whether the title deeds of all the immovable properties (other than properties where the company is the lessee and the lease agreements are duly executed in favor of the lessee) disclosed in the financial statements are held in the name of the company, if not, provide the details thereof in the format below -

Description of property	Gross Carrying Value	Held in name of	Whether Promoter, director or their relative or employee	Period held -indicate range, Where appropriate	Reason for not being held in name of company*
-	-	-	-	-	*also indicate if in dispute

As regards the modification, we see the introduction of the prescribed format. The points for consideration under this clause are:

- i. The meaning of immovable property was always a topic of debate. The Guidance Note on CARO, 2020 makes reference to the General Clauses Act, 1897 which defines Immovable Property to include "land, benefits to arise out of land, and things attached to the earth, or permanently fastened to anything attached to the earth". It further states that in case of Real Estate Company, inventories of immovable property must not be considered. Thus it can be implied that the auditor can consider PPE (including ROU Assets), Investment Property and Assets Held for Sale when reporting under this clause.
- ii. This clause is a statement of facts. The auditor is not required to opine or comment on the rightful ownership of the immovable property. The auditor merely needs to ensure that a title deed exists.
- iii. In cases where immovable property is mortgaged to third parties. The auditor should not rely on photocopies of the title deeds provided by the auditee. The auditor should obtain confirmation from the third parties or ensure examination of the original documents representing title deeds. Where the auditor is not able to obtain sufficient appropriate audit evidence regarding the title deeds of immovable properties, adequate disclosure must be made when reporting under this clause.

#### **Clause 3(i)(d) - Revaluation**

This clause requires the auditor to report 'Whether the company has revalued its Property, Plant and Equipment (including Right of Use assets) or intangible assets or both during the year and, if so, whether the revaluation is based on the valuation by a Registered Valuer; specify the amount of change, if change is 10% or more in the aggregate of the net carrying value of each class of Property, Plant and Equipment or intangible assets'. The points for consideration under this clause are as follows -

- i. The auditor must keep in mind that the accounting aspects of revaluation of intangible assets as dealt with in AS 26, "Intangible Assets" is different than that dealt with in Ind AS 38, "Intangible Assets". AS 26 follows the Cost model while Ind AS 38 follows the Cost and Revaluation model. An instance was identified when a company required to report in accordance with Accounting Standards has reported under this clause as follows:

*"The company has not revalued its Property, Plant and Equipment or intangible assets or both during the year. Accordingly, reporting under clause 3(i)(d) of the Order is not applicable."*

It is pertinent to note here that revaluation of intangible assets is not applicable to the company and thus makes the statement erroneous. Thus, reporting under this clause must be done keeping in mind the applicable financial reporting framework.

- ii. The auditor must also keep in mind that revaluations done in the previous periods need not be commented upon.
- iii. There is also a possibility where a registered valuer's report is not obtained by the company. The auditor needs to disclose this fact when reporting under this clause.

#### ***Clause 3(ii)(b) – Working Capital***

This clause requires the auditor to comment on whether during any point of time of the year, the company has been sanctioned working capital limits in excess of five crore rupees, in aggregate, from banks or financial institutions on the basis of security of current assets and whether the quarterly returns or statements filed by the company with such banks or financial institutions are in agreement with the books of account of the company. The points for consideration under this clause are as follows:

- i. There arose ambiguity in cases where the working capital limits were sanctioned on the basis of security of other than current assets. It is pertinent to note that the intent of introduction of this clause is to curb the frauds identified in the past of artificial inflation of inventory and debtors at the time of reporting to the banks and financial institutions. The auditor is therefore required to only report on the working capital limits sanctioned on the basis of security of current assets.
- ii. The auditor is also required keep in mind that reporting is with respect to the 'Sanctioned Limits' in excess of Rs. 5 crores. Thus, even though the utilization of such facilities is lower than the threshold mentioned, the auditor must report under this clause.
- iii. The auditor must also be careful in case of the treatment of non fund based facilities. For example, there is a possibility that certain non fund based facilities may be availed for capital expenditure. The auditor must make subjective evaluation in such cases, whether such facilities will be included when reporting under this clause.

#### ***Clause 3(iii)(a) – Loans and Investments***

The duty of the auditor, under this clause, is to determine whether the company during the year has provided loans or provided advances in the nature of loans, or stood guarantee, or provided security to any other entity. If the company has done so, the auditor should report on the matters specified.

- i. The clause was modified to include 'advances in the nature of loans'. The interpretation of advances to be in the nature of loans is a very subjective decision and will require the auditor to exercise professional judgement when reporting under this clause. The guidance note on Schedule III provides us with a couple of examples in this respect. It says that an advance given for: a) an amount which is far in excess of the value of an order; or b) for a period which is far in excess of the period for which such advances are usually extended as per the normal trade practice, may be in the nature of a loan to the extent of such excess.

#### ***Clause 3(iii)(e) – Loans***

This clause requires reporting in respect of loan or advance in the nature of loan granted which has fallen due during the year and has been renewed or extended or fresh loans granted to settle the overdue of existing loans given to the same parties. This clause is inserted to identify instances of 'evergreening' of loans/advances in nature of loans.

- i. A peculiar scenario where the auditor may face challenges when reporting under this clause is in cases of round tripping of the funds. For example a loan given by the auditee to Co. 'A' which in turn loans the money to Co. 'B' which in turn loans the money to Co. 'C' which in the end loans the same money to

the auditee. Now if 'C' were to default it would be a challenge for the auditor to look at scenarios beyond the first layer of funding and thus reporting under this clause will have to be looked at carefully. The RBI governor has also pointed out this issue on several occasions to curb this malpractice.

#### ***Clause 3(viii) – Undisclosed Income***

This clause has been newly introduced. Reporting under this clause shall be applicable only when the transactions not recorded in the books of account have been surrendered or disclosed as income during the year in the income tax assessments. If yes, then the auditor shall also report on proper recording of the same in the books of account during the year.

- i. This clause casts two responsibilities upon the auditor. The first being a statement of fact – Whether there has been an instance of voluntary surrender or disclosure of income during the year. The other being a matter of opinion – whether such details are 'properly' recorded in the books of account. The auditor must be mindful of these responsibilities and report accordingly.
- ii. The auditor should also bear in mind that disputed additions are not required to be reported under this clause.

#### ***Clause 3(ix)(b) – Wilful Defaulter***

Under this clause, the auditor is required to report whether the company has been declared as a wilful defaulter by any bank or financial institution or any other lender.

- i. The auditor should consider the facts and circumstances when reporting under this clause. There have been instances of differences of opinion arising between the auditor and the auditee with regards to show cause notices issued asking the company reasons as to why it should not be declared a wilful defaulter. Reporting under this clause will not be applicable if the conclusion to the show cause notice issued is pending.
- ii. Where this clause becomes applicable and the company has been determined a wilful defaulter, it is advised that the auditor look into the going concern assumption as well.
- iii. Banks come out with lists of wilful defaulters. The board minutes may also have details which may help the auditor in reporting under this clause. The auditor may also seek confirmations from the banks/ financial institutions when reporting under this clause. However, confirmations may not be sought in cases where the payments have been consistently being made by the company.

#### ***Clause 3(ix)(d) – Utilization of loan taken***

This clause requires the auditor to comment whether the funds raised on short-term basis have been used for long-term purposes. The points for consideration when reporting under this clause are:

- i. It is pertinent to note that the clause does not mention the use of short-term loans for long term assets. It uses the terminology of long-term purposes. The auditor should examine each scenario carefully and ensure that when reporting under this clause 'long term assets' and 'long term purposes' are not used interchangeably even though most scenarios would indicate the same. Under this clause, Comparison would be required for long term sources and application of funds.

**Clause 3(ix)(e) – Group Company Obligation**

Reporting under this clause would normally be required when the company has taken any funds from any entity or any person and has also granted loans or advances in the nature of loans to its subsidiaries, associate companies or joint ventures or has made further investments in such subsidiaries, joint ventures, or associate companies.

- i. The auditor must note that when reporting under this clause, the consequent impact on reporting under clauses 3(ix)(c) and 3(ix)(d) is also taken into consideration. The auditor of a listed company reported under this clause stating that the holding company issued short term commercial papers for the purchase of equity shares in a subsidiary. However, under clause 3(ix)(d) the auditor has reported that no short term loans were taken for long term purposes.

**Clause 3(xiv)(a) – Internal Audit**

The points for consideration under this clause are as follows:

- i. This clause requires the auditor to ‘comment’ whether the company has an internal audit system commensurate with the size and nature of its business. This involves the auditor’s professional judgement. There have been instances noticed when Section 138 of the Companies Act, 2013 is applicable and a certain area that is significant for the entity’s business is scoped out of the internal audit. The auditor should evaluate whether such instances need to be reported.
- ii. It has been noticed in the recent past that even though Section 138 of the Companies Act, 2013 is not applicable to certain companies, they have employed an internal audit function on a voluntary basis. The auditor is required to report under such circumstances as well. Mere statutory requirement does not trigger reporting under this clause.
- iii. Another area of professional diligence for the auditor when reporting under this clause is the correlation between the Internal Financial Controls over Financial Reporting (IFCoFR) report and the Internal Audit report. There have been instances where control deficiencies were identified under IFCoFR and the Internal Audit report had failed to highlight these deficiencies. The auditor when reporting under this clause has maintained the stance that the internal audit system of the company does not commensurate with the size and nature of its business.

**Clause 3(xviii) – Statutory Auditor Resignation**

Under this clause, the auditor is required to report if there has been any resignation of the statutory auditors during the year. This clause also requires the auditor to consider the issues, objections or concerns raised by the outgoing auditors in case of resignation. The points for consideration under this clause are as follows:

- i. The auditor while reporting under this clause must bear in mind that change of auditors due to mandatory rotation is not covered under this clause.
- ii. In case of joint audits where one of the joint auditors resigns, the continuing auditor is required to consider the reason for such resignation and report under this clause.

**Conclusion:**

CARO 2020 is a significant piece of legislation that has the potential to improve the quality of corporate reporting in India. However, it is important to monitor the impact of the new order in the coming years to ensure that it is not too burdensome for the auditors or any other stakeholder.

