# CARO 2020: Enhanced reporting

**Released at the 7th KARCC event**

March 2022

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# Foreword

### *About CARO 2020*

The Companies Act, 2013 (2013 Act) requires auditors of specified class of companies to include a statement in their reports on specific matters as prescribed in the Companies (Auditors' Report) Order (CARO). In 2020, the Ministry of Corporate Affairs (MCA) issued a revised CARO (CARO 2020) which is applicable to wide range of companies. It has been revised to help curb corporate scams and intends to introduce transparency and accountability in the audited financial numbers.

CARO 2020 is applicable for audits of financial years commencing on or after 1 April 2021.

CARO 2020 contains significant changes and several new reporting requirements *vis-à-vis* CARO 2016. Many of the requirements require exercise of judgement rather than application of a pure objective test.

The Institute of Chartered Accountants of India (ICAI) has issued a guidance note on CARO 2020 (guidance note) which provides guidance on application of the CARO 2020. The guidance note supersedes the guidance note issued by ICAI in April 2016.

Further, to align the auditor's reporting requirement with the disclosures provided by the companies, on 24 March 2021, the MCA has issued a slew of amendments to Schedule III to the 2013 Act[1]. The amendments are effective from 1 April 2021. Schedule III disclosures along with the reporting requirements under CARO 2020 are aimed at enabling a higher level of corporate governance.

Some of the important areas where reporting has been enhanced are material uncertainty around repayment of liabilities, adequacy of internal audit, whistle-blower system, borrowings, investment, loans and advances, and reporting on matters relating to consolidated entities.

Companies would need to ensure that adequate systems, processes and internal controls are in place to facilitate implementation of the new reporting requirements. Additionally, these would involve maintenance of proper and sufficient records of the underlying information to be disclosed as part of their financial statements as well to be furnished with the auditors to ensure timely compliance with the requirements.

### *About this publication*

This publication has been designed to assist companies in understanding guidance surrounding topics covered in CARO 2020. It contains 10 chapters and various clauses of the CARO 2020 have been grouped under easy to understand topical headings.

The publication discusses the reporting requirements as envisaged under the new auditor's report - CARO 2020 and Schedule III, and related implications for companies. It also highlights key guidance provided by ICAI in its guidance note.

### *Need for judgement*

This publication intends to highlight some of the practical considerations while reporting under CARO 2020. Therefore, interpretation and significant use of judgement may be required for a company to apply CARO 2020 to its facts, circumstances and individual transactions. Further, some information contained in this publication may change as practice and implementation guidance continue to develop. Users are advised to read this publication in conjunction with the actual text of the CARO 2020, Schedule III, guidance note issued by the ICAI, and to consult their professional advisors before concluding on the requirements of CARO 2020.

### *References*

References to relevant guidance and abbreviations, when used, are defined within the text of this publication.

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1. Schedule III to the 2013 Act provides general instructions for presentation of financial statements of a company under both Accounting Standards (AS) and Indian Accounting Standards (Ind AS).

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No change | Modified | New provision



* There is no change in terms of applicability of CARO to companies. However, CARO 2020 has introduced a new reporting requirement wherein an auditor is required to comment whether there have been any qualifications or adverse remarks in the CARO reports of the companies included in the consolidated financial statements by the respective auditors.

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No change | Modified | New provision

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# CHAPTER 1

# Applicability of CARO 2020

Similar to CARO 2016, CARO 2020 is applicable to every company including a foreign company (as defined under the 2013 Act).

It will not apply to banks, insurance companies, companies licensed to operate under Section 8 of the 2013 Act, one person and a small company.

Additionally, it will not apply to a private limited company if it meets all of the following conditions:

a. It is not a subsidiary or holding company of a public company

b. Its paid-up capital and reserves and surplus do not exceed INR1 crore as on the balance sheet date

c. Its total borrowings do not exceed INR1 crore from any bank or financial institution at any point of time during the Financial Year (FY)

d. Its total revenue as disclosed in Scheduled III to the 2013 Act (including revenue from discontinuing operations) do not exceed INR10 crore during the financial year as per the financial statements.

CARO 2020 would be equally applicable to the audit of branch(es) of a company as to a company and audits of project office/liaison office established outside India.

# Consolidated Financial Statements (CFS)

CARO 2020 is not applicable to the auditor's report on CFS. However, an auditor is required to state in its report details of companies included in CFS with qualifications or adverse remarks by their respective auditors. This would include reporting of qualification/ adverse remark made by every individual component including the parent.

## Guidance by ICAI

ICAI in its guidance note clarified that compliance with the requirements of CARO 2020 by a company need to be evaluated with reference to the whole accounting year and not merely with reference to the position existing at the balance sheet date or a date at which an auditor makes his/her report.

## CHAPTER 2

# Property, plant and equipment and intangible assets

# Property, Plant and Equipment (PPE)

Currently, an auditor is required to report on maintenance of proper records including quantitative details and situation of fixed assets. One of the change made in the CARO 2020 is that the term fixed assets has been replaced with Property, Plant and Equipment (PPE). This in accordance with Indian Accounting Standards (Ind AS), 16, *Property, Plant and Equipment* and Accounting Standard (AS) 10 (Revised), *Property Plant and Equipment*, the term 'fixed assets' has been replaced with PPE.

Accordingly, CARO 2020 requires an auditor to report whether the company is maintaining proper records and those records show full particulars, including quantitative details and situation of the **PPE**. Similar to CARO 2016, it also requires reporting on whether **PPE** have been physically verified by the management at reasonable intervals. Further, in case of any material discrepancies noticed on such verification, whether the same have been properly dealt with in the books of account.

*(Emphasis added to highlight the additions made vis-à-vis CARO 2016).*

## Guidance by ICAI

The reporting requirement would extend to cover right-of-use assets held by the company as a lessee, an investment property as defined under Ind AS 40, *Investment Property* and non-current assets held for sale under Ind AS 105.

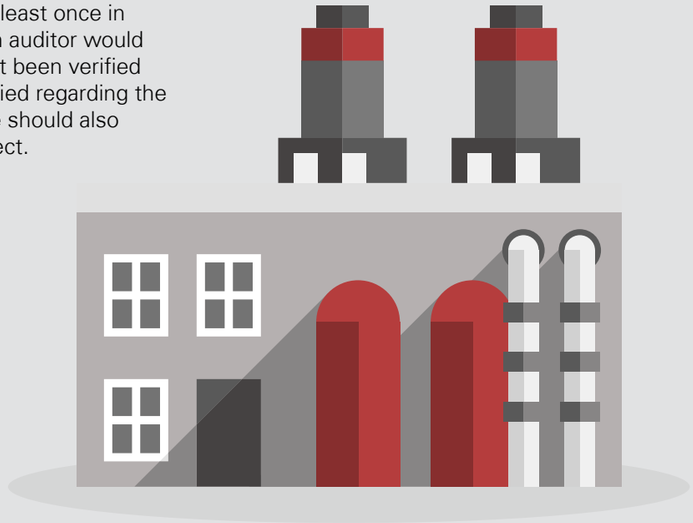
For the purpose of this clause, companies would be required to maintain 'proper records' of all items of PPE including those which have been fully depreciated, impaired or retired from active use and held for disposal. The records should at a minimum include details relating to the year of purchase, original cost, useful life, component-wise breakup, adjustment for revaluation or for any increase or decrease in cost and accumulated depreciation.

The aggregate original cost, depreciation to date, and impairment loss, if any, as per these records under individual heads should reconcile with the figures shown in the books of account of the company.

The purpose of showing the situation of PPE is to make verification possible. Companies might have certain classes of PPE whose situation keeps changing, for instance construction equipment which has to be moved to sites. In such cases, it would be a sufficient requirement if company maintains record of movement/custody of the equipment.

As management needs to ensure physical verification of PPE at reasonable intervals, the guidance note clarifies that an annual verification might be considered a reasonable period. However, annual verification could be impracticable in some cases. Therefore, management may decide upon the periodicity of physical verification considering various factors such as number of assets, the nature of assets, the relative value of assets, difficulty in verification, etc. Where an annual verification of entire PPE is not carried out, it should be ensured that verification programme should be such that all assets are verified at least once in every three years. In this situation, an auditor would report the fact that all assets have not been verified during the year. If the auditor is satisfied regarding the frequency of verification, then he/she should also make a suitable comment to that effect.

An auditor is required to exercise professional judgement while determining *material* discrepancies in a physical verification of PPE. While making this judgement, an auditor would not only consider the cost of the asset and its relationship to the total cost of all assets but also the nature of the asset, its situation and other relevant factors.

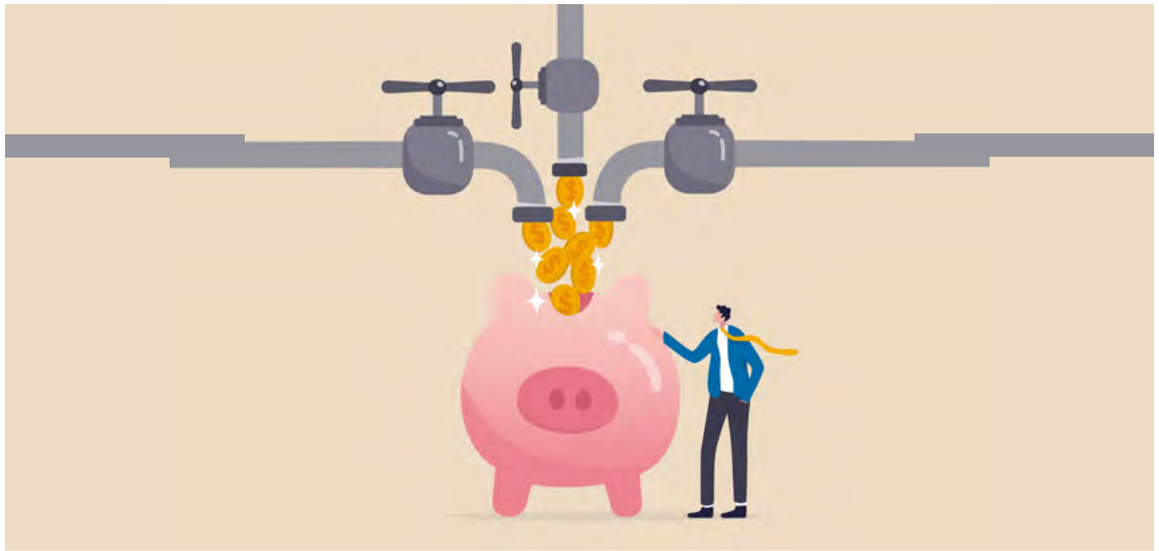


# Intangible assets

CARO 2020 introduces a new reporting requirement as per which an auditor is required to comment on whether the company is maintaining proper records that show full particulars of intangible assets. The intangible assets could, *inter alia*, include, customer loyalty, patents, internet domain names, royalty agreements, operating rights and website development.

## Guidance by ICAI

For the purpose of reporting under this clause, reasonable and sufficient description of the asset to facilitate identification should be made available by the company. Additional information that needs to be recorded should include, location of the asset, original cost details, date on which the asset becomes available for use by the company with documentary evidence, rate(s)/basis of amortisation, accumulated amortisation and particulars regarding impairment.



# Revaluation of PPE/intangible assets

CARO 2020 introduces a new reporting requirement as to whether a company has revalued its PPE (including right-of-use assets), intangible assets, or both during the year. If so, it further requires reporting on whether the revaluation is based on the valuation by a registered valuer and specify the amount of change, if change is 10 per cent or more in aggregate of the net carrying value of each class of PPE or intangible assets.

## Guidance by ICAI

Unlike the cost model which allows only downward adjustment in the carrying amount of an asset due to impairment loss, revaluation model allows both an upward and downward adjustment in the carrying amount of an asset as per the provisions of Ind AS 16/AS 10. As per the guidance note, for the purpose of reporting under this clause, revaluation would not include:

- Fair valuation of PPE upon first-time adoption of Ind AS
- Remeasurements (i.e., changes in value due to interest or foreign exchange rates)
- Changes to right-of-use assets due to lease modification as per Ind AS 116, *Leases*.

An auditor would be required to consider the requirements of Section 247 of the 2013 Act relating to valuation by registered valuers. Various other aspects that can be considered for reporting under this clause would include, date of revaluation carried by the company, methods and significant assumptions applied in estimating fair values and accounting treatment of revaluation surplus.

# Disclosures under Schedule III to the 2013 Act (Modified disclosure)

*Notes to the balance sheet*

Schedule III to the 2013 Act requires separate disclosure of a reconciliation of the gross and net carrying amounts of each class of assets at the beginning and end of the reporting period showing additions, disposals, acquisitions through business combinations, **amount of change due to revaluation (if change is 10 per cent or more in the aggregate of the net carrying value of each class of PPE/intangible assets)**. Other adjustments and the related depreciation and impairment losses/reversals are to be separately disclosed.

**Further, where the company has revalued its PPE (including right-of-use assets)/ intangible assets, the company shall disclose as to whether the revaluation is based on the valuation by a registered valuer as defined under Rule 2 of the Companies (Registered Valuers and Valuation) Rules, 2017.**

*(Emphasis added to highlight the change made by MCA vide notification dated 24 March 2021).*

# Benami property

A new requirement added by CARO 2020 relates to reporting on whether any proceedings have been initiated or are pending against the company for holding any benami property[2] under the Prohibition of Benami Property Transactions Act, 1988 (Benami Property Act) and rules made thereunder. If so, whether the company has appropriately disclosed the details in its financial statements.

## Guidance by ICAI

The reporting under this clause would require ascertainment of whether proceedings have been initiated under the Benami Property Act by the Initiating Officer[3] during the year and/or any proceedings are pending against the company before the Initiating Officer/Adjudicating Authority/ Appellate Tribunal/High Court/Supreme Court during any of the preceding financial years. The reporting is not applicable where the notice is received by the company as a beneficial owner.

For the purpose of reporting, appropriate disclosures in the financial statements would include nature of property, carrying value of the property in the books of account, status of proceedings before the relevant authority, consequential impact on the financial statements and/or the liability that may arise in case the proceedings are decided against the company. Also, it needs to be evaluated whether the liability is required to be disclosed as 'contingent liability' or whether provision is required to be made.

2. Benami property means any property which is the subject matter of a benami transaction and also includes the proceeds from such property.
3. An authority who initiates the proceedings under the Benami Property Act.

# Disclosures under Schedule III to the 2013 Act (New disclosure)

*Notes to balance sheet - As part of additional regulatory information*

Where any proceeding has been initiated or pending against the company for holding any benami property under the Benami Property Act (as amended in 2016) and rules made thereunder, a company is required to disclose the following:

a. Details of benami property
b. Amount thereof
c. Details of beneficiaries
d. If property is in the books, then reference to the item in the balance sheet
e. If property is not in the books, then the fact shall be stated with reasons
f. Where there are proceedings against the company under this law as an abetter of the transaction or as the transferor then those details shall be provided,
g. Nature of proceedings, status and company's view on same.

# Title deed of immovable property

CARO 2020 has modified the requirement relating to holding title of immovable properties by the company *vis-a-vis* CARO 2016. As per the modified requirement, an auditor is required to report on 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 favour of the lessee) disclosed in the financial statements** are held in the name of the company. If they are not held in the name of the company, then following details (as given in the table below) are required to be provided:

| 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*<br><br>(*also indicate if in dispute) |
|---|---|---|---|---|---|
| | | | | | |

*(Emphasis added to highlight the change made by CARO 2020)*

## Guidance by ICAI

The reporting under this clause would be only in respect of those immovable properties which form part of PPE and would cover an investment property as defined under Ind AS 40 and non-current assets held for sale.

The term 'immovable property' has not been defined under the 2013 Act. However, as per General Clauses Act, 1897, immovable property would include land, benefits to arise out of land, and things attached to the earth, or permanently fastened to anything attached to the earth. Accordingly, Transfer Development Rights (TDRs), plant and machinery embedded in land, etc., will not be considered as an immovable property.

It is important to note that the management is responsible for legal determination of the validity of title deeds. Title deeds in general mean a legal deed or document constituting evidence of a right, especially to the legal ownership of the immovable property. For instance, registered sale deed, conveyance deed of land or land and building together, etc. transferred by any person including government to the company. An auditor would verify the title deeds available and reconcile the same with the PPE register.

Specific disclosure would be required in case the immovable property is being held by the promoter, director or their relative. In accordance with the amendments to Schedule III, the term 'relative' would mean relative as defined under the 2013 Act.

Accordingly, relative with reference to any person would mean anyone who is related to another, if:

a. They are members of a Hindu Undivided Family (HUF)

b. They are husband and wife or

c. One person is related to the other in such manner as may be prescribed.

Though reporting in cases where immovable property is held by a company as a lessee and lease agreements are duly executed has not been covered under this clause, however, with respect to cases where there are discrepancies in lease agreements or it is not duly executed, it would be prudent to include in the report, facts of such a case. Further, in cases where the lessor company has received immovable property under long-term lease and has given the same to other party on sub-lease, lease deed executed in favour of the lessor would be verified to ascertain whether the title of those long-term leasehold immovable properties relate to the lessor.

Support of a legal expert could be sought in case there is any dispute or litigation as to the title of the immovable property or where the auditor seeks clarity in matters related to the reporting under this clause.

# Disclosures under Schedule III to the 2013 Act (New disclosure)

*Notes to balance sheet - As part of additional regulatory information*

A company is required to provide the details of all the immovable property (other than properties where the company is the lessee and the lease agreements are duly executed in favour of the lessee) whose title deeds are not held in the name of the company in the given format. Where such immovable property is jointly held with others, details are required to be given to the extent of the company's share.

| Relevant line item in the balance sheet | Description of item of property | Gross carrying value | Title deeds held in the name of | Whether title deed holder is a promoter, director or relative[4] of promoter[5]/director or employee of promoter/director | Property held since which date | Reason for not being held in the name of the company** |
|---|---|---|---|---|---|---|
| PPE | Land<br>Building | | | | | ***Also indicate if in dispute* |
| Investment property | Land<br>Building | | | | | |
| PPE retired from active use and held for disposal | | | | | | |
| Others | | | | | | |

4. Relative means relative as defined in the 2013 Act.
5. Promoter means promoter as defined in the 2013 Act.

## Key considerations

CARO 2020 enhances the scope of matters to be provided in an auditor's report. While auditors would need to implement robust audit procedures along the requirements, companies on the other hand, would also need to ensure that they maintain proper and adequate records of the underlying information. Additionally, companies would need to ensure that they have systems and processes to capture the new reporting requirements as envisaged by CARO 2020, such as:

- Maintenance of adequate records with respect to right-of-use assets and intangible assets held by the company including details of physical verification of right-of-use assets.
- Details of revaluation of PPE including right-of-use assets and intangible assets during the year along with maintaining records of registered valuers and the valuation reports issued by them.
- Details of proceedings initiated or pending against the company as the holder of a benami property including status of proceedings before the relevant authority and other requisite details to be furnished in the financial statements in respect of such proceedings. Additionally, assess whether provisions are to be created consequent to such proceedings.
- Maintenance of title deeds of all immovable properties held by the company along with details of immovable properties not in the name of the company (with specific distinction of those held by promoter, director or their relative or employee) and the reason for the same. This disclosure would also include properties on lease (ROU) as any deviation (where agreement for lease is not in the name of the company) would need to be reported.

# CHAPTER 3

# Physical inventory verification and working capital sanction

Inventories are assets held for sale in the ordinary course of business, in the process of production of such sale or in the form of materials or supplies to be consumed in the production process or in the rendering of services. Generally, inventories form a significant portion of the total assets of a company. Therefore, verification and audit of inventories is an important area. It is important to note that management of a company is responsible to ensure that inventories included in the financial information are physically in existence and represent all inventories owned by the entity. It is required to establish procedures under which inventory is physically counted at least once a year to serve as a basis for the preparation of the financial statements and, if applicable, to ascertain the reliability of the entity's perpetual inventory system. On the other hand, an auditor is also required to report on the periodicity of the physical verification along with highlighting the material discrepancies, if any, under CARO 2020.

Companies require working capital to cater their day-to-day operational fund requirements. It generally indicates the liquidity levels of the company for managing day-to-day expenses and covers inventory, cash, accounts payable, accounts receivable and short-term debt that is due. CARO 2020 specifically require that the auditor's should report in respect of working capital sanctioned by banks or financial institutions on the basis of security of current assets, in excess of INR5 crore.

# Physical verification of inventory

CARO 2020 has modified the reporting requirement relating to inventory verification by companies *vis-à-vis* CARO 2016. As per the revised requirement, an auditor is required to comment on whether the management has conducted physical verification of inventories at **reasonable intervals** and whether the **coverage and procedure of such verification by the management is appropriate**, in the opinion of the auditor. Further, it requires an auditor to report whether any discrepancies of **10 per cent or more in the aggregate** for each class of inventory have been noticed and if so, whether they have been properly dealt with in the books of account. Only material discrepancies were required to be reported under CARO 2016.

*(Emphasis added to highlight the addition made by CARO 2020)*

## Guidance by ICAI

### *Reasonable interval*

As per the guidance note, what constitutes 'reasonable interval' would depend on circumstances of each case. The periodicity of the physical verification of inventories depends upon the nature of inventories, their location and the feasibility of conducting a physical verification. However, wherever practicable, all the material items of inventories should be verified by the management of the company at least once in a year. Companies may determine the frequency of verification by 'A-B-C' classification of inventories i.e., 'A' category items being verified more frequently than 'B' category. 'B' category items being verified more frequently than 'C' category items.

### *Appropriate coverage and procedure of verification*

Though physical verification of inventories is primarily the duty of the management, an auditor is expected to examine the methods, procedures and the coverage of such verification. What constitutes 'appropriate' while determining coverage and procedure of verification is a matter of professional judgement. The coverage and procedure of such verification will be inappropriate if it is not reasonable and adequate in relation to the size of the company and nature of its business.

To verify the appropriateness and effectiveness of the procedures, an auditor may be present at the time of stock-taking and can also perform test-counts

## Guidance by ICAI

including comparison of final inventories with stock records and other corroborative evidence e.g., inventory statements submitted to banks, etc. Further, an auditor would also examine the following documents:

a. Written instructions given by the management to the concerned staff engaged in the physical verification process

b. Physical verification inventory sheets duly authenticated by the field staff and responsible officials of the company

c. Summary sheets/consolidation sheets duly authenticated by the responsible officials

d. Internal memos, etc., with respect to the issues arising out of physical verification of inventory

e. Extent of coverage of inventory with regard to their value

f. Any other relevant documents evidencing physical verification of inventory.

Third party confirmation may also be obtained by an auditor for stock held with them.

### *Discrepancies and related treatment in the book of account*

An auditor is required to report cases where discrepancy of 10 per cent or more arises in value for any class of inventory along with commenting on whether they have been properly dealt with in the books of account. If not appropriately accounted, the extent of the discrepancies and its impact on the financial statements need to be reported.

The threshold for reporting i.e., 10 per cent should be applied on a net basis after adjusting excesses and shortages within the class of an inventory and should be based on value for each class of inventory. For this purpose, materiality threshold as may be applicable for the auditee would not be relevant; rather discrepancy of 10 per cent or more in value, for any class of inventory, which may or may not be material would be reported. The calculation of discrepancy would be made at the time of physical verification of inventory. In case of perpetual inventory system, book stock, physical stock and discrepancies would be aggregated for computing the threshold of 10 per cent.


# Working capital sanction

CARO 2020 has introduced a new reporting requirement wherein an auditor is required to comment on whether during any point of time of the year, the company has been sanctioned working capital limits in excess of INR5 crore, in aggregate, from banks or financial institutions on the basis of security of current assets. Further, an auditor is also required to report whether the quarterly returns or statements filed by the company with such banks or financial institutions agree with the books of account of the company. If not, then details are to be provided in the auditor's report.

## Guidance by ICAI

Reporting under this clause would not cover:

- Unsecured working capital, if any sanctioned
- Working capital sanctioned on the basis of assets, other than current assets
- Utilisation of working capital sanctioned.

### *Sanctioned limit*

As per the guidance note, the term 'sanction' would include fresh sanction during the year as well as limits renewed or due for renewal during the year. The sanctioned limit of INR5 crore would be determined with reference to the sanction letter issued by banks or financial institutions and relevant agreements executed with them. It would include both fund and non-fund based credit facilities availed by the company.

The limit of INR5 crore would cover the working capital limits from all the banks and financial institutions in aggregate excluding any working capital limits which are sanctioned without the security of the company's current assets.

It is important to note that the sanctioned limit of INR5 crore would be examined for any day during the year for which the reporting is to be made and not as at the end of the financial year. Accordingly, if the limit exceeds INR5 crore even on a day during the year, the same would be reported.

## Guidance by ICAI

***Quarterly returns/statements filed with banks and financial institutions***

Management is required to submit certain **quarterly** returns/statements to banks and financial institutions. These would include - stock statements, book debt statements, credit monitoring arrangement reports, statements on ageing analysis of the debtors/other receivables, and other financial information submitted in a stipulated format to lenders. Only those statements/returns which have relevance with books of account of the company are subject to review and reporting under this clause. Those would be compared with the books of account and disagreement, if any, would be reported in the auditor's report. For instance, difference in value of stock, amount of debtors/creditors, ageing analysis of debtors, etc.

In case, where a company submits monthly returns/statements to the lenders instead of quarterly return (e.g., separate return for the month of April, May and June), an auditor would verify returns/statements as at the end of each quarter (i.e., for the month of June only, being relevant return as at the end of the quarter) and not for other months of the same quarter.

## Disclosures under Schedule III to the 2013 Act (New disclosure)

*Additional regulatory information - Notes to the balance sheet*

Where a company has borrowings from banks or financial institutions on the basis of security of current assets, it shall disclose the following:

a. Whether quarterly returns or statements of current assets filed by the company with banks or financial institutions are in agreement with the books of accounts

b. If not, summary of reconciliation and reasons of material discrepancies, if any, to be adequately disclosed.

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## Key considerations

While companies are expected to ensure compliance with the requirements of CARO 2020, some of the requirements would also require them to initiate processes to facilitate reporting by an auditor, in particular, those relating to identification of discrepancies in inventory verification and working capital sanctioned. For instance, to corroborate coverage and procedures of inventory verification, proper underlying records and documents for each class of inventory would be required to be maintained by a company. Additional records would be required for working capital sanctioned exceeding INR5 crore at any time during a year irrespective of its utilisation wherein the balance could exceed the limit due to excess withdrawals/ levy of interest/temporary overdrawings. It is important to note that companies are required to disclose all kinds of borrowings from banks or financial institutions which have been obtained on the basis of security of current assets. An auditor, on the other hand, is required to comment on the working capital sanctioned in excess of INR5 crore in the auditor's report.

# CHAPTER 4

# Loans and investments and repayment of dues

In general, companies engage in borrowing or lending activities from/to other entities including their subsidiaries, joint ventures and associates for their business operations. In the recent past, various instances of corporate failures have been reported on account of failure to meet their repayment obligations or siphoning of funds/utilisation of funds for purposes other than business purpose. In order to assess the veracity of such loans and borrowings, CARO 2020 introduces various reporting requirements on following aspects:

- Investments made, guarantee/security or loans/advances in the nature of loans provided by companies
- Compliance with provision of Section 185 and 186 of the 2013 Act
- Default in repayment of loans and other borrowings by companies
- Situations when a company is declared as a wilful defaulter
- Purpose for which term loans have been applied
- Situations where short-term funds have been applied for long-term purposes
- Funds raised to meet obligations of subsidiaries, associates or joint ventures
- Funds raised on pledge of securities held in subsidiaries, joint ventures or associates.

In line with the above changes to CARO 2020, MCA has also introduced new disclosures to be made by companies in their financial statements effective 1 April 2021. We will discuss each one of them in the given section.


# Investments and loans and advances in the nature of loans made by companies

CARO 2020 has modified the requirement relating to providing loans and advances by companies *vis-à-vis* CARO 2016 and has also added few new reporting requirements.

As per the revised requirement, an auditor is required to report whether the company has made **investments in, provided any guarantee or security** or granted any loans **or advances in the nature of loans**, secured or unsecured, to companies, firms, Limited Liability Partnerships (LLPs) or **any other parties**. Therefore, in addition to loans, the revised clause covers reporting on investments made, guarantee or security provided or advances in the nature of loans granted by companies.

The reporting requirement under this clause are sub-divided into six clauses (which has been discussed in subsequent sections).

*(Emphasis added to highlight the addition made by CARO 2020)*

## Guidance by ICAI

An auditor is required to comment on each of the sub-clause and in respect of all loans/advances in nature of loans granted, guarantee or security provided to companies, firms, LLPs or any other parties. Further, all kind of loans i.e., long-term/short-term, in cash or in kind given by the company to any party would be covered.

## Loans, advances in the nature of loan and guarantee/security provided

CARO 2020 has introduced a new reporting requirement relating to whether the company has provided loans or advances in the nature of loans, or stood guarantee, or provided security to any other entity during the year. If the answer is yes, then it would need to indicate:

A. The aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to subsidiaries, joint ventures and associates.

B. The aggregate amount during the year, and balance outstanding at the balance sheet date with respect to such loans or advances and guarantees or security to parties other than subsidiaries, joint ventures and associates.

### Guidance by ICAI

The clause would be applicable to all companies except companies whose principal business is to give loans e.g., financial institutions, NBFCs or NBFC registered as core investment company.

Determination of whether an advance is in the nature of a loan would depend upon the circumstances of each case. For instance, an advance given in excess of the value of an order or for a period which is in excess of the period for which such advances are usually extended as per the normal trade practice, could be considered as an advance in the nature of a loan to the extent of such excess.

Further, reporting under this clause would cover only financial guarantee given by a company to a bank or financial institution in respect of loans taken by a third party.

For the purpose of reporting, an auditor would be required to determine the gross amount (i.e., without adjusting any subsequent settlements) of all loans, advances in nature of loans, guarantees, security provided **during the year** (emphasis added) to subsidiaries, joint ventures, associates[6] and to any other parties. Loans/advances in nature of loan that have been squared-up (i.e., given and repaid) during the year would also be reported under this clause.

In addition to the sectoral laws such as guidelines prescribed by RBI in respect of NBFCs, an auditor would be required to evaluate compliance with the requirements of relevant provisions of the 2013 Act dealing with power of the board of directors with respect to granting of loans, norms relating to loans granted to directors, and loans and investments made by companies (i.e., Section 179, 180, 185, 186 and 187 of the 2013 Act).

## Terms and conditions not prejudicial to the company's interest

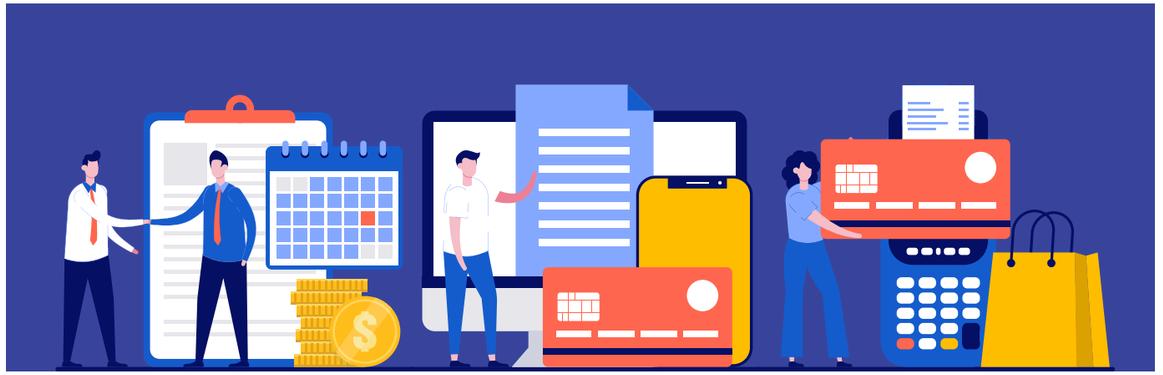
CARO 2020 has modified the reporting requirement and requires an auditor to comment on whether the terms and conditions of the **investments, guarantee, security, all loans/advances in the nature of loans** granted during the year are not prejudicial to the interest of the company.

*(Emphasis added to highlight the additions made vis-à-vis CARO 2016)*

### Guidance by ICAI

Reporting under the clause would be applicable to all companies including financial institutions, NBFCs, etc.

A due consideration would need to be given to the terms and conditions of the loans/advances in the nature of loans/investments made/guarantee/security provided. Other factors would also be considered such as company's ability to lend/make an investment/ borrow and financial standing of the borrower/ investee/party on whose behalf the company has given the guarantee. As per the guidance note, financial support by a holding company to its loss-making subsidiary would not be construed as prejudicial to the interest of the holding company.



6. The definition of subsidiary, joint venture and associates would be construed in accordance with the 2013 Act.

## Schedule of repayment of principal and interest

**In respect of loans and advances in the nature of loans**, an auditor is also required to report on stipulation of schedule of repayment of principal and payment of interest and on regularity of their repayments i.e., the principal and interest should normally be received whenever they fall due.

*(Emphasis added to highlight the additions made vis-à-vis CARO 2016)*

### Guidance by ICAI

Reporting under this clause would be applicable to all companies and would cover:

- Loans and advances in nature of loans granted during the year
- Loans and advances in nature of loans with opening balances and
- Advances in nature of loans which do not contain the schedule of repayment and payment of interest.

The clause requires examination of loan agreements, mutually agreed letter of arrangement, schedule of repayment of principal and payment of interest, etc. In certain cases where there is no loan agreement/ arrangement or the loan agreement/arrangement do not contain the schedule of repayment of principal and payment of interest, then the auditor would need to report this fact along with his/her inability to make a specific comment on the regularity of repayment of principal and payment of interest.

Additionally, where a schedule of repayment of principal or payment of interest is stipulated but such payments are not regular then an auditor may report this fact and may give number of such cases and remarks.

## Amount overdue for more than 90 days

Similar to CARO 2016, CARO 2020 requires an auditor to disclose the total amount overdue (i.e., principal and interest) for more than 90 days from all parties as at the balance sheet date. The auditor would also report whether reasonable steps have been taken by the company for recovery of the principal and interest.

There is no major change in the reporting requirement *vis-à-vis* CARO 2016. This clause would cover loans given by the company to any party.

### Guidance by ICAI

Reporting under this clause would be applicable to all companies. As per the guidance note, facts and circumstances of each case including the amount involved would need to be considered by an auditor while examining whether reasonable steps (not necessarily legal steps) have been taken by the company for recovery of principal and interest.

Management of a company would need to provide in writing the steps taken by the management for recovery of the principal and interest.

## Renewal of loans/fresh loans to settle overdues of existing loans

CARO 2020 introduces a new reporting requirement in respect of a loan or an 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 overdues of existing loans given to the same parties i.e., identification of instances of 'evergreening'[7] of loans/advances in the nature of loans.

### Guidance by ICAI

Reporting under the clause would be applicable to all companies except companies whose principal business is to give loans for example, financial institutions, NBFCs or NBFC registered as a core investment company.

As per the guidance note, reporting under this clause would also cover loans falling due as on the balance sheet date and which were renewed/ extended/settled post balance sheet date and before the date of audit report. Such instances would be reported in subsequent year as well. The clause is not restricted to 'overdue' loans but also extends to situations where fresh loans are given close to settlement date.

7. The term 'evergreening' is not defined in the 2013 Act. However, in general parlance it implies an attempt to mask loan default by giving new loans to help delinquent borrowers to repay/adjust principal or pay interest on old loans.

## Loans granted to promoters and related parties

CARO 2020 has introduced another new clause which requires disclosure of gross amount of loans or advances in the nature of loans which are either repayable on demand or do not specify any terms or period of repayment in the auditor's report. If a company has granted such loans, then specific disclosures would need to be provided for aggregate amount of loans granted to promoters and related parties as defined under relevant provisions of the 2013 Act.

### Guidance by ICAI

As per the guidance note, such relationship (promoter or related party) may exist at any point during the year. Reporting under the clause would be applicable to all companies.

# Disclosures under Schedule III to the 2013 Act (New disclosure)

*Notes to balance sheet - As part of additional regulatory information*

Where loans or advances in the nature of loans are granted to promoters, directors, Key Managerial Personnel (KMP) and the related parties (as defined under the 2013 Act), either severally or jointly with any other person, that are:

a. Repayable on demand or

b. Without specifying any terms or period of repayment,

then a company is required to make disclosures in the following format:

| Type of borrower | Amount of loan or advance in the nature of loan outstanding | Percentage to the total loans and advances in the nature of loans |
|---|---|---|
| Promoters | | |
| Directors | | |
| KMPs | | |
| Related parties | | |

# Compliance with provisions of Section 185 and 186 of the 2013 Act

CARO 2020 brings forward this reporting requirement from CARO 2016. This requirement relates to whether the company has complied with the provisions of Section 185 and 186 of the 2013 Act in respect of loans, investments, guarantees, and security provided in connection with loans.

As per the provisions of Section 185 of the 2013 Act, a company cannot advance any loan, including loan represented by a book debt, directly or indirectly to any of its directors. Such a restriction also extends to any guarantee given or security provided in connection with a loan. However, companies are allowed to give loans (including loan represented by a book debt), any guarantee or can provide any security in connection with any loan, to any person in whom any of the director is interested[8], subject to prior approval by a special resolution and loans should be utilised by the borrowing company for its principal business activities.

Further, Section 186 of the 2013 Act governs the provisions relating to granting loans, guarantee or security and making investments by companies in other entities. While making investments, a company is not allowed to enter into certain transactions if the amount involved in the transaction exceeds 60 per cent of paid-up share capital, free reserves and securities premium account or 100 per cent of its free reserves and securities premium account, whichever is more, except by way of a special resolution passed at a general meeting. It also prohibits a company from making investments through more than two layers of investment companies, unless specifically exempted.

8. Any person in whom any of the director of the company is interested' means:
   i. Any private company of which any such director is a director or member
   ii. Any body corporate at a general meeting of which not less than 25 per cent of the total voting power may be exercised or controlled by any such director, or by two or more such directors, together
   iii. Any body corporate, the BoD, MD or manager, whereof is accustomed to act in accordance with the directions or instructions of the BoD, or of any director or directors, of the lending company.

## Guidance by ICAI

In respect of loan or related guarantee/security given by a company to its directors, the nature of the non-compliance, the maximum amount outstanding during the year and the amount outstanding as at the balance sheet date would be reported in respect of:

- Directors and
- Any person in whom any of the director of the company is interested (specifying the relationship with the director concerned).

With respect to loans and investments by companies to other entities, companies would need to disclose full particulars of the loan given, investment made or guarantee given or security provided in the financial statements including the purpose for which the same is proposed to be utilised by the recipient. Further, it would involve assessment of rate of interest, which should not be lower than the prevailing yield of government security, special resolution duly passed in case loans exceed the specified limits and prior approval from the public financial institution where any term loan is subsisting.

# Default in repayment of loans or other borrowings by companies

Unlike CARO 2016, CARO 2020 requires an auditor to report on whether the company has defaulted in repayment of loans/other borrowings **or in the payment of interest thereon** to **any lender** (earlier reported only in case of defaults in repayment to a financial institution, bank or government) in a specified format as given below:

| Nature of borrowing, including debt securities | Name of lender* | Amount not paid on due date | Whether principal or interest | No. of days delay or unpaid | Remarks, if any |
|---|---|---|---|---|---|
| | *lender wise details to be provided in case of defaults to banks, financial institutions and government. | | | | |
| | **Other lenders:** Aggregate for each type of lender may be given, for example, debenture holders. | | | | |

*(Emphasis added to highlight the additions made vis-à-vis CARO 2016)*

### Guidance by ICAI

The clause covers defaults in payment of loans or other borrowings (including principal and interest) to any lender.

It also covers rescheduled/restructured loans, disputed loans and loans and borrowings on demand.

For the purpose of reporting under this clause, borrowings will not include public deposits and preference share capital. As per the guidance note, reporting under this clause would cover:

- Amount of all defaults[9] committed during the year along with number of days of default
- Amount and period of defaults existing at the balance sheet date irrespective of when those defaults have occurred.

Period up to the date of the auditor's report would be considered for the purpose of reporting the number of days delay or amount that remains unpaid.

In case a loan is rescheduled or restructured, it has been clarified that mere submission of application would not mean that no default has occurred. In case the application for reschedulement of loan has been approved by the concerned bank or financial institution during the year covered by the auditor's report, then this fact would be reported by the auditor. However, if reschedulement has been approved subsequent to the balance sheet date, defaults during the year would be reported.

Further, in case of disputes between the lender and the company regarding repayment, prevailing terms and conditions would be considered by an auditor and a brief about nature of dispute would be reported.

## Wilful defaulter

CARO 2020 introduces a new reporting requirement relating to whether the company has been declared as a wilful defaulter by any bank or financial institution or other lender.

### Guidance by ICAI

As per the guidance note, reporting under this clause would be restricted to the relevant financial year under audit till the date of auditor's report. The term 'wilful default' has been defined by RBI in its circular on wilful defaulters[10] which, *inter alia*, includes occurrence of any of the following events as a wilful default:

- The unit has defaulted in meeting its payment/ repayment obligations to the lender even when it has the capacity to honour the said obligations
- The unit has defaulted in meeting its payment/ repayment obligations to the lender and has diverted the funds for purposes other than for which it was availed or has siphoned off the funds
- The unit has defaulted in meeting its payment/ repayment obligations to the lender and has also disposed-off or removed the movable or immovable property given by it for the purpose of securing a term loan without the knowledge of the bank/lender.

The term 'lender' under the RBI circular covers all banks/financial institutions to which any amount is due. Considering the objective of the clause, the guidance note has clarified that the clause would cover any bank or financial institution even if such a bank or financial institution has not lent to the company. In respect of 'other lenders', reporting would be restricted to declaration of wilful defaulter by government/government authorities.

Further, if a company has not been declared a wilful defaulter but has received a show-cause notice in accordance with the RBI circular, the auditor may consider disclosing this fact in its report.

Apart from obtaining direct confirmations from banks/financial institutions, an auditor may examine monthly reports submitted by banks and financial institutions to the credit information companies such as Credit Information Bureau (India) Limited (CIBIL) including verification of database of Central Repository of Information on Large Credits (CRILC), set up by RBI to collect, store, and disseminate credit data to lenders for the purpose of reporting under this clause.

9. The term 'default' for the purpose of reporting under this clause would mean non-payment of dues to lenders on the last dates specified in loan documents or debentures trust deed, as the case may be.
10. RBI master circular RBI/2014- 15/73DBR.No.CID.BC.57/20.16.003/2014-15 dated 1 July 2014.

# Disclosures under Schedule III to the 2013 Act (New disclosure)

*Notes to balance sheet - As part of additional regulatory information*

Where a company is a declared wilful defaulter[11] by any bank, financial institution or other lender, then a company shall give following details:

a. Date of declaration as a wilful defaulter

b. Details of defaults (amount and nature of defaults).

## Application of term loans

Another new reporting requirement under CARO 2020 relates to whether term loans were applied for the purpose for which these loans were obtained. If not, then the auditor is also required to report the amount of loan so diverted and the purpose for which it is used.

Additionally, MCA through a circular dated 24 March 2021 had issued certain amendments to the Companies (Audit and Auditor) Rules, 2014 (Audit Rules) under the 2013 Act. In accordance with the amendments, an auditor is required to include his/her views and comments on the following additional matters in the auditor's report:

a. The management has represented that to the best of its knowledge and belief, other than as disclosed in the notes to the accounts:

   i. No funds have been advanced or loaned or invested (either from borrowed funds, share premium or any other sources/kind of funds) by the company to/in any other person(s) or entity(ies), including foreign entities (intermediaries), with the understanding (recorded in writing or otherwise) that the intermediary shall, whether, directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company (ultimate beneficiaries) or provide any guarantee, security or the like on behalf of the ultimate beneficiaries

   ii. No funds have been received by the company from any person(s) or entity(ies), including foreign entities (funding parties), with the understanding (recorded in writing or otherwise) that the company shall, whether, directly or indirectly, lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the funding party (ultimate beneficiaries) or provide any guarantee, security or the like on behalf of the ultimate beneficiaries

b. Based on such audit procedures that the auditor has considered reasonable and appropriate in the circumstances, nothing has come to its notice that has caused an auditor to believe that the representations under points (i) and (ii) above contain any material misstatement

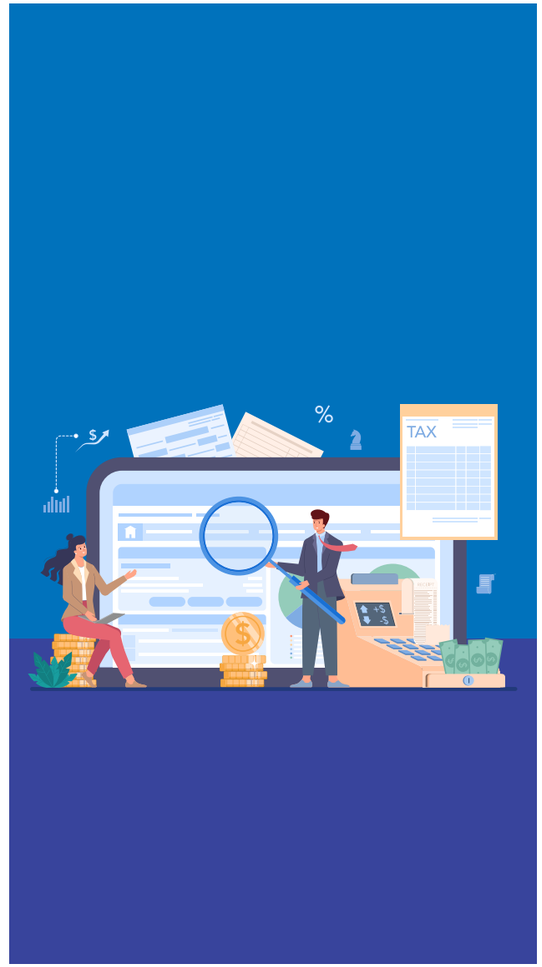
c. The dividend declared or paid during the year by the company is in compliance with Section 123 of the 2013 Act

d. The company has used such accounting software for maintaining its books of account which has a feature of recording audit trail (edit log) facility. Further, an auditor should also comment on whether:

   i. The audit trail feature has been operated throughout the year for all transactions recorded in the software

   ii. The audit trail feature has not been tampered with and

   iii. The audit trail has been preserved by the company as per the statutory requirements for record retention.




11. Wilful defaulter means a person or an issuer who or which is categorised as a wilful defaulter by any bank or financial institution (as defined under the 2013 Act) or consortium thereof, in accordance with the guidelines on wilful defaulters issued by RBI.

## Guidance by ICAI

Term loans generally carry a repayment period of more than 36 months. Therefore, term loans would not cover cash credit, overdraft and call money accounts/deposits. As per the guidance note, terms loans obtained from entities/persons other than banks/financial institutions would also be covered for the purpose of reporting under this clause.

The RBI circular on wilful default defines diversion of funds to, *inter alia*, include any of the following events:

- Utilisation of short-term working capital funds for long-term purposes not in conformity with the terms of sanction
- Deploying borrowed funds for purposes/activities or creation of assets other than those for which the loan was sanctioned
- Investment in other companies by way of acquiring equities/debt instruments without approval of lenders.

Therefore, if the company has applied the general-purpose loan for any such purpose which can be defined as a diversion, an auditor would be required to report it accordingly. Further, utilisation of term loans which have been split as equity and debt components under the accounting framework would be considered in entirety for the purpose of reporting under this clause.

There could be a situation that a company took a term loan during the year but did not apply for the stated purpose as the loan was disbursed at the end of the year. An auditor would be required to state this fact in his/her report. Additionally, the clause covers term loans which were taken in the previous accounting period but were utilised during the current accounting period.

## Disclosures under Schedule III to the 2013 Act (New disclosure)

*Notes to the balance sheet*

Currently, where in respect of an issue of securities made for a specific purpose the whole or part of amount has not been used for that specific purpose at the balance sheet date, companies are required to disclose by way of note how such unutilised amounts have been used or invested.

In addition to the current requirements, where the company has not used the borrowings from banks and financial institutions for the specific purpose for which it was taken at the balance sheet date, then they it is required to disclose the details of where they have been used.

Additionally, following new disclosures are required to be provided:

A. Where a company has advanced, loaned or invested funds (either borrowed funds, share premium or any other sources or kind of funds) to any other person(s) or entity(ies), including foreign entities (intermediaries) with the understanding (whether recorded in writing or otherwise) that the intermediary shall:

   i. Directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the company (ultimate beneficiaries) or

   ii. Provide any guarantee, security or the like to or on behalf of the ultimate beneficiaries, the company shall disclose the following:

   a. Date and amount of fund advanced or loaned or invested in intermediaries with complete details of each intermediary.

   b. Date and amount of fund further advanced or loaned or invested by such Intermediaries to other intermediaries or ultimate beneficiaries alongwith complete details of the ultimate beneficiaries.

   c. Date and amount of guarantee, security or the like provided to or on behalf of the ultimate beneficiaries.

   d. Declaration that relevant provisions of the Foreign Exchange Management Act, 1999 and 2013 Act has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering Act, 2002.

B. Where a company has received any fund from any person(s) or entity(ies), including foreign entities (funding party) with the understanding (whether recorded in writing or otherwise) that the company shall:

i. Directly or indirectly lend or invest in other persons or entities identified in any manner whatsoever by or on behalf of the funding party (ultimate beneficiaries) or

ii. Provide any guarantee, security or the like on behalf of the ultimate beneficiaries, the company shall disclose the following:

a. Date and amount of fund received from funding parties with complete details of each funding party.

b. Date and amount of fund further advanced or loaned or invested other intermediaries or ultimate beneficiaries alongwith complete details of the other intermediaries' or ultimate beneficiaries.

c. Date and amount of guarantee, security or the like provided to or on behalf of the ultimate beneficiaries

iii. Declaration that relevant provisions of the Foreign Exchange Management Act, 1999 and 2013 Act has been complied with for such transactions and the transactions are not violative of the Prevention of Money-Laundering Act, 2002.

## Application of short-term funds for long-term purposes

CARO 2020 introduces a new reporting requirement relating to whether funds raised on short-term basis have been utilised for long-term purposes. If the answer is yes, then an auditor would be required to report the nature and amount so utilised.

### Guidance by ICAI

The underlying principle for the requirement is to assess financial health of an entity. For the purpose of reporting under this clause, long-term sources of funds along with their long-term application by a company would be determined using the data contained in the financial statements. Long-term sources of funds would include share capital, reserves and surplus, long-term debt securities and long-term loans and long-term application of funds could be investment in property, plant and equipment, intangible assets and repayment/ redemption of long-term loans/debt.

As per the guidance note, if the quantum of long-term funds is significantly less than the long-term application of funds, then it would be an indication that short-term funds have been used to finance the long-term assets of the company. Further, a current ratio of less than one would also be an indicator that short-term funds have been used to finance long-term assets of the company.

## Funds raised to meet obligations of subsidiaries, associates or joint ventures

Another new reporting requirement relates to whether the company has taken any funds from any entity or person on account of or to meet the obligations of its subsidiaries, associates or joint ventures[12]. If yes, then an auditor is required to provide the details along with the nature of such transactions and the amount in each case.

### Guidance by ICAI

As per the guidance note, reporting under this clause would normally be required when the company has taken any funds from any entity/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.

Funds could be short-term or long-term and could be obtained from any entity irrespective of the legal form. Further, reporting under this clause would cover:

- All funds taken during the year even if these have been repaid before the year end
- Funds taken in earlier years and were repaid during the year or are outstanding as at the year end.

Though the term obligation has not been defined in the 2013 Act or in CARO 2020, it would in general mean the amounts that the subsidiaries, joint venture or associate companies are required to pay themselves either to their vendors, lenders, employees, or statutory authorities.

For the purpose of reporting, an auditor may examine schedule of loans and advances/borrowings and related party transactions maintained by the company along with obtaining direct confirmations from subsidiaries, joint venture or associate companies. In case financial statements of subsidiaries, joint ventures, and associates are audited by another auditor, it may also seek specific information from the auditors of the components.

12. For the purpose of this clause, the term subsidiary, associate or joint venture would be as defined under the 2013 Act.

## Funds raised on pledge of securities held in subsidiaries, joint ventures or associates

Under CARO 2020, an auditor is also required to report whether the company has raised loans during the year on the pledge of securities[13] held in its subsidiaries, joint ventures or associate companies. In case the answer is affirmative, it requires an auditor to:

- Give details of such loans and
- Report if the company has defaulted[14] in repayment of such loans raised.

### Guidance by ICAI

'Securities held in its subsidiaries, joint ventures or associate companies' would mean the investment of the company (reporting entity) in such subsidiary, joint venture or associate company.

Reporting under this clause would cover:

- All loans taken (from any lender) during the year even if repaid during the year. Accordingly, loans taken in earlier years and outstanding as at the balance sheet date would not be covered
- Cases where security has been invoked by the lender on account of default by the company
- Only specific pledge of securities and not general or residual charge on all securities.

In accordance with the 2013 Act, companies are required to create a charge in case a company obtains a loan by pledge of securities. Companies would need to maintain documents related to charges created including any modification thereof including loan agreements/other documents such as term sheets for the purpose of verification by an auditor.

13. The term 'securities' would mean securities as defined under Section 2(h) of the Securities Contracts (Regulation) Act, 1956 (SCRA) which include, shares, scrips, stocks, bonds, debentures, or other marketable securities, derivative and government securities.
14. Default will include both repayment of principal and payment of interest.

## Key considerations

Schedule III disclosures and CARO 2020 with its new bundle of clauses aims to provide a comprehensive position of the loans and advances taken or given by a company. Some of the key reporting requirements introduced relate to:

- Loans or advances in the nature of loans which are either repayable on demand or do not specify any terms or period of repayment with a specific disclosure on such loans given to promoters or related parties. In terms of disclosures required under Schedule III and to facilitate reporting by an auditor, companies would need to provide separate disclosure for loans or advances in the nature of loans which:
  a. Are either repayable on demand or
  b. Do not specify any terms or period of repayment.
- Specific reporting on evergreening of loans i.e., granting new loans for repayment of old loans in order to prevent a default.
- Application of terms loans for the purpose for which those have been raised, if not, then specific reporting on amount so diverted.
- Funds taken to meet the obligations of subsidiaries, associates or joint ventures along with those taken on pledge of securities held by the company in subsidiaries, associates or joint ventures.
- Default in repayment of loans/borrowings by a company to any lender.
- When a company is declared as a wilful defaulter.

These reporting requirements cast an additional responsibility on the management of the company to ensure that all documents and relevant processes are in place for an auditor to verify and report accordingly.

***Diversion of funds through an intermediary***

- The 2013 Act has been amended and it requires auditors to seek specific representation affirming that there has been no illegitimate diversion of funds through an intermediary. This would need to be reviewed and reported by an auditor in the auditor's report.

- The amendment needs to be carefully evaluated as it could cover practically all types of outflows/inflows including funds advanced in the form of supplier advances. Additionally, the term 'intermediary' has not be defined and may also cover a branch, subsidiary, associate or joint venture. It seems whenever a company makes an investment in another company, gives loans or advances, it may have to put in place a mechanism for tracking the end use of the funds, where relevant. Also a company would need to demonstrate the source of the funds raised and inter-linkages of its use along with an end use confirmation from the counterparty.

***Use of accounting software with audit trails***

The amendment requires every company that uses an accounting software for maintaining its books of account to ensure that it provides an audit trail and help prevent fraudulent activities through data tampering. This requirement is applicable from 1 April 2022. Additionally, for companies that would be unable to implement this amendment from 1 April 2022, an auditor would be required to comment on the non-compliance aspect of the accounting software amendment.

Some of the other key points to consider are:

- **Term 'accounting software':** The amendment does not provide any clarity on the term 'accounting software'. One interpretation could be that only the main accounting software that generates financial statements would be covered under this amendment. Companies may have a range of subsystems supporting the main accounting software and they would need to evaluate whether such subsystems would also be covered within the meaning of the term accounting software. Also companies should consider the situations where accounting function has been outsourced or they use an accounting software of their group companies.
- **Types of accounting software:** As this amendment applies to every company that uses an accounting software. Companies would need to assess their present systems as to whether they would be able to facilitate the implementation of the new requirement of maintaining an audit trail for each transaction and ensure that this feature should not be disabled during the year.
- **Applicable throughout the accounting year:** As per the amendment, the audit trail feature should be operated throughout the year for all transactions recorded in the software. Companies should consider this aspect while implementing this amendment and ensure that the systems are compliant with these new requirements from the first day of the coming financial year.
- **Retention of electronic records:** The audit trail has to be preserved by a company as per the statutory requirements for record retention. Accordingly, the data providing the audit trail would be part of the electronic records required to be retained by the company from 1 April 2022 onwards.

# CHAPTER 5

# Acceptance of deposits and payment of statutory dues

Companies cater to their financial needs in various forms, such as raising capital through issuance of shares/ debentures, acquiring funds from lending institutions, etc. An alternate mode through which companies fulfil their financial needs is through acceptance of deposits from members or public. Stringent provisions are laid down under the 2013 Act with respect to acceptance of deposits by a company. With a view to ensure whether these provisions are followed in spirit by the companies, CARO 2020 requires the auditors to report on the compliances met by companies *vis-à-vis* deposits accepted by them.

Companies are also obliged to make certain payments under various laws and regulations such as sales-tax, Tax Deducted at Source (TDS), Provident Fund (PF), income-tax, duty of customs, etc. These amounts are to be deposited with the concerned regulatory authorities within the prescribed timelines. Delay or non-payment of such dues attracts penal provisions. Therefore, companies need to ensure that these are paid in a timely manner. Non-compliances with the relevant provisions are also required to be reported in the auditors' report.

# Acceptance of deposits by a company

CARO 2020 has modified the reporting requirement relating to acceptance of deposits by a company *vis-à-vis* CARO 2016 and includes reporting on 'amounts which are deemed to be deposits'. As per the revised clause, an auditor is required to report whether the directives issued by RBI and the provisions of Sections 73 to 76 or any other relevant provisions of the 2013 Act and the rules made thereunder, where applicable, have been complied with, in respect of deposits accepted by the company or **amounts which are deemed to be deposits**. If the answer is no, then an auditor is required to report the nature of such contraventions.

Also, if an order has been passed by the Company Law Board (CLB), National Company Law Tribunal (NCLT), RBI, any court or any other tribunal, whether the same has been complied with or not is also required to be reported.

*(Emphasis added to highlight the addition made by CARO 2020 vis-à-vis CARO 2016)*

## Applicability of provisions of the 2013 Act

The deposit related provisions under the 2013 Act are applicable to the following classes of companies:

- A company that accepts deposits from its *members*. Such a company has to pass a resolution in its general meeting according to the Companies (Acceptance of Deposits) Rules, 2014 (Deposits Rules) and subject to the fulfilment of the specified conditions (Section 73(2))
- A company that is eligible to accept deposits from the *public* (Section 76) (i.e., eligible company[15] as defined under the Deposits Rules.

However, certain companies are exempted from the deposit related provisions and they are as follows:

- A banking company
- A NBFC
- A housing finance company
- A company as may be specified by the Central Government (CG) after consultation with RBI.

15. An eligible company means a public company fulfilling the following conditions:
    a. Net worth of not less than INR100 crore or a turnover of not less than INR500 crore
    b. Obtained prior consent of the company in the general meeting by means of a special resolution*, and
    c. Filed the said resolution with the Registrar of Companies (ROC) before making any invitation to the public for acceptance of deposits
    (*In case, deposit is with respect to the limits specified under Section 180(1)(c) of the 2013 Act, an ordinary resolution may suffice the requirement.)

## Definition of term 'deposits' and 'amount deemed to be deposits'

Section 2(31) of the 2013 Act defines 'deposit' to include any receipt of money by way of deposit or loan or in any other form by a company but does not include such categories of amount as may be prescribed in consultation with RBI. Further, the Deposits Rules provide various categories and items that are excluded from the definition of deposits.

Some of the significant items which are not to be categorised as deposits except in specific situations where they can be classified as *deemed deposits* are as follows:

- **Receipt of amount towards subscription of securities in certain situations**: An amount received towards subscription of securities would not be treated as a deposit except in the following situations:
  a. The securities against which amount has been received could not be allotted within 60 days from the date of receipt of the application money, or
  b. Advance for such securities and application money or advance has not been refunded to the subscribers within 15 days from the date of completion of 60 days.

As per the guidance note, the above receipts of amount (point (a) and (b)) would be considered as *deemed deposits*.

- **Receipt of amount for the purpose of business:** Any amount received in the course of, or for the purposes of, the business of the company would not be treated as a deposit. For example, amount received as:
  a. An advance for the supply of goods or provision of services provided that such an advance is appropriated against supply of goods or provision of services within a period of 365 days from the date of acceptance of such advance
  b. An advance received in connection with consideration for an immovable property under an agreement/arrangement, provided that such advance is adjusted against such property in accordance with the terms of the agreement/arrangement
  c. An advance received under long-term projects for supply of capital goods except those covered under (b) above
  d. Security deposit for the performance of the contract for supply of goods or provision of services
  e. An advance towards consideration for providing future services in the form of a warranty or maintenance contract as per the written agreement/arrangement, if the period for providing such services does not exceed the period prevalent as per common business practice, or five years from the date of acceptance of such service, whichever is less.

  However, above amounts would be *deemed to be deposits* on the expiry of 15 days from the date they become due for refund.

If an amount (given in point (a), (b) or (c) above) becomes refundable (with or without interest) due to the reasons that the company accepting the money does not have necessary permission or approval, wherever required, to deal in the goods or properties or services for which the money was taken, then the amount received would be *deemed to be a deposit*.

## Conditions for acceptance of deposits

A company (including eligible company) intending to invite deposits is required to comply with certain conditions while accepting deposits. These, *inter alia*, include:

- **Maintenance of liquid assets:** On or before 30 April of each year, an amount not less than 20 per cent of the amount of deposits maturing during the following FY should be kept in a scheduled bank (in a separate bank account) to be called as 'deposit repayment reserve account.'

  Such a reserve should be used only for the purpose of repayment of deposits.

- **Credit rating**
  - *Eligible company:* Every eligible company is required to obtain at least once in a year, a credit rating for deposits accepted by it and the copy of such rating should be sent to the Registrar of Companies (ROC) along with the return of deposits in Form DPT-3.

    Such a credit rating should not be below the minimum investment grade rating or other specified credit rating for fixed deposits from any one of the approved credit rating agencies (as specified for NBFCs).
  - *Company covered under Section 73(2):* Company taking deposits from its members also needs to provide credit rating obtained, issued to its members.

- **Repayment of deposits:** A company should not default in the repayment of the deposit (or interest thereon) accepted before or after the commencement of the 2013 Act. Companies which have made good on a default committed in the past are allowed to accept deposits after five years from the date of default remediation.

## Other considerations

- **Permissible amount of deposits:** The 2013 Act along with the Deposits Rules, prescribes the following limits for acceptance of deposits from members and the public:
  - *Eligible company (excluding government company):* An eligible company is allowed to accept deposits of up to 10 per cent of the aggregate of its paid-up share capital, free reserves and securities premium account from its members.

    In case of any other deposits, deposits of up to 35 per cent of the aggregate of the paid-up share capital, free reserves and securities premium account are permitted.
  - *Other company (i.e., public company which is not an eligible company and private company):* Such other company is allowed to accept deposits of up to 35 per cent of its paid-up share capital, free reserves and securities premium account from its members.
  - *Private company:* A private company is allowed to accept deposits of up to 100 per cent of the aggregate of its paid-up share capital, free reserves and securities premium account from its members and does not have to comply with the conditions specified under Section 73(2) of the 2013 Act. It has to file details of monies so accepted with ROC in Form DPT-3.
- **Disclosures:** Following disclosures are required:
  a. **Return of deposits:** Every company is required to file with the ROC a return of deposits (comprising information contained therein as on 31 March of that year duly audited by the auditor of the company) in Form DPT-3, on or before 30 June of every year along with the specified fees. Every company, other than a government company should use Form DPT-3 (return of deposits) for filing:
     i. A return of deposit
     ii. Particulars of a transaction not considered as deposit or
     iii. Both

  b. **Disclosure in financial statements:** Every company is required to disclose the amount received from the director (also relatives of directors in case of a private company) in the notes to the financial statements.

### Guidance by ICAI

The guidance note requires reporting on compliance by the company with regard to all matters specified in Sections 73 to 76 of the 2013 Act by an auditor. In case of companies with large number of deposits, examination of system by which deposits are accepted and records are maintained by the company should be done. With respect to assessment of amounts which could be deemed to be deposits, companies should maintain a list of amounts received in the course of, or for the purposes of, the business of the company (for instance, advances and security deposits) for an auditor to verify.

Further, an examination of the efficacy of the internal controls instituted by the company so that the deposits accepted by the company remain within the limits should be done.

In addition to commenting on the compliance with the provisions of the 2013 Act relating to deposits accepted by a company, an auditor is required to report on compliance with any order, if issued by the CLB, NCLT, RBI, any court or any other tribunal in response to contravention of provisions relating to deposits or any other relevant provisions of the 2013 Act and the rules thereunder. Accordingly, companies would need to inform about all such instances along with the steps taken to comply with the order to an auditor. In case of non-compliance with the order issued by CLB, NCLT, RBI, any court, or any other tribunal, the fact would be reported along with the nature of contravention in the auditor's report.

# Payment of statutory dues

Another reporting requirement that has been modified by CARO 2020 vis-à-vis CARO 2016 relates to payment of statutory dues by a company. As per the revised clause, an auditor is required to report on the regularity of payment of the company in depositing undisputed statutory dues including **Goods and Services Tax (GST)**, PF, employees' state insurance, income-tax, sales-tax, service tax, duty of custom, duty of excise, value added tax, cess and any other statutory dues to appropriate authorities.

If the company is not regular in depositing the stated undisputed statutory dues, then an auditor is further required to state the extent of arrears of statutory dues which have remained outstanding as at the last day of the financial year concerned for a period of more than six months from the date they became payable.

*(Emphasis added to highlight the addition made by CARO 2020)*

Additionally, in case the above-mentioned statutory dues have not been deposited on account of any dispute, then an auditor is required to report the amounts involved and the forum where dispute is pending. Under CARO 2016, this reporting was restricted to non-payment of income-tax, sales-tax, service-tax, duty of customs, duty of excise and value added tax on account of any dispute.

It is to be noted that mere representation to the concerned department would not be treated as a dispute for the purpose of reporting under this clause.

## Guidance by ICAI

### *Regularity of payment of statutory dues*

As per the guidance note, the term 'any other statutory dues' would cover all types of dues under various statues which may be applicable to a company having regard to its nature of business. Therefore, an auditor would be required to comment on the regularity of the company in depositing any other statutory dues payable by the company to appropriate authorities under the statutes applicable to the company, in addition to the ones specifically listed under the clause.

As the intent of reporting is to ascertain how regular the company is in depositing statutory dues with the appropriate authorities, the scope of reporting would be limited to cover only those statutory dues which the company is required to deposit regularly to an authority under a statue. Consequently, the reporting would not cover those amounts which may be levied by an appropriate authority from time to time upon occurrence or non-occurrence of certain events and therefore, are not required to be paid regularly. Following are examples of dues which will not be classified as statutory dues for the purpose of reporting under this clause:

a. Any sum payable to an electricity company as electricity bill as the due has arisen on account of supply of goods or services between the parties.

b. Dividend payment to shareholders under the 2013 Act as the same is on account of contractual obligation with the shareholders.

   However, dividend declared and not paid to the shareholders within specified time limit, and which is required to be transferred to a specified fund would be considered as a statutory due.

c. Bonus to an employee

d. Any sum payable to public sector undertakings, despite the fact that such undertakings are incorporated, owned and operated by the state government/CG.

It is to be noted that any dues recoverable as arrears of land revenue by the concerned authority would be treated as a statutory due.

Further, while assessing the regularity of payment, due consideration needs to be given to the nature of the statutory dues. With respect to some of the dues such as PF, GST, etc., regularity could be a normal feature as companies are required to deposit the money with appropriate authorities on a monthly or quarterly basis. However, in case of other dues such as duty of custom on import of goods, demands arising on account of assessment orders, etc., wherein a company is required to pay as and when an event giving rise to the liability of the company occurs, payments would be considered regular if the company deposits them as and when they occur. Though, reporting would cover regularity of the company in depositing the installments, if any, granted by an authority in respect of a demand against the company.

Accordingly, non-payment of advance income-tax and non-deduction of TDS would constitute default in payment of statutory dues. Erroneous adjustments of one category of GST credit with other category without appropriately applying the prevailing laws would also be considered as default in payment to be reported.

### *Period of default and amounts payable*

Reporting under this clause would cover all such cases where the company has been in default in depositing the statutory dues anytime during the year, irrespective of the fact that there are no arrears on the balance sheet date.

For the purpose of reporting, statutory dues would be considered as payable:

- As at the date of the expiry of the stay granted by the authorities or
- Where installments have been granted for the payment of statutory dues, the date on which the default occurs, and the amount becomes payable to the authorities.

Reporting would be restricted to actual arrears and would not include the amounts which have not fallen due for payment to appropriate authority and have been recognised as outstanding dues at the balance sheet date. However, penalty and/or interest levied under the respective laws would be covered within the term 'amounts payable'.

As per the guidance note, while indicating the arrears, the period to which the arrears relate should preferably be given and further, wherever possible, the fact of subsequent clearance or otherwise may also be indicated by an auditor in its report.

### *Disputed statutory dues*

In case of non-payment of any statutory due on account of any dispute, an auditor is required to state the amounts involved irrespective of the treatment of such disputed amounts in books of accounts along with the forum where the dispute is pending. The reporting would cover minor amounts as well.

As per the guidance note, a matter would be considered as 'disputed', where there is a positive evidence or action on the part of the company to show that it has not accepted the demand for payment of tax or duty, e.g., where the company has gone into an appeal. Further, in case the demand notice/ intimation for the payment of a statutory due is for a certain amount and the dispute relates only to a part and not the whole of such amount, then only that part of amount would be treated as disputed. Balance amount would be regarded as undisputed.

Issuance of a show cause notice by the concerned department should not be construed to be demand payable by a company. Though, tax demands which have been stayed by the relevant authority would be regarded as disputed dues. Further, in cases where the appellate authority has decided a case in favour of a company, but the department may prefer to make an appeal to a higher authority, there will be no dispute until the time the department makes an appeal to the relevant appellate authority. In case where amount under dispute is pending for an appeal to be filed and the time limit for filing the appeal has lapsed, then the disputed amount would become a statutory due.

## Key considerations

To facilitate reporting, companies may need to maintain a list of various statutes under which they are required to make payments regularly to appropriate authorities, the kind of payments under each statute, the due date for making the payment to the appropriate authority, the date on which the payment is made by the company, the arrears not due and the arrears overdue for more than six months along with the underlying documents for an auditor to verify and report accordingly.

Also, companies may need to maintain adequate system to identify amounts which may be considered as deemed deposits under the 2013 Act and consequently, would need to ensure compliances with the provisions of the 2013 Act with respect to such deposits.

# CHAPTER 6

# Fraud reporting and qualification in an auditor's report

In recent times, the corporate frauds have shaken the confidence of various stakeholders, in particular the investors. Therefore, there is a rise in expectations from the auditors to bring to the fore instances of frauds or other such unethical practices which would be key for decision-making by investors. With this objective, CARO 2020 has introduced reporting requirements relating to fraud by the company or on the company including whistle-blower complaints received by it during the year. Additionally, auditors are specifically required to report transactions which have not been recorded in the books of account but have been surrendered or disclosed as income during the year in the tax assessments under the Income-tax Act, 1961 (IT Act). Consequent to the changes in CARO 2020, MCA has also introduced new reporting requirement relating to undisclosed income in the financial statements.

Further, in order to provide a comprehensive view about company's operations at consolidated level, CARO 2020 also requires auditors to report about qualifications or adverse remarks in the auditors' reports of the companies included in the Consolidated Financial Statements (CFS) of the parent company.

# Fraud reporting

CARO 2020 has modified the reporting requirement relating to fraud *vis-à-vis* CARO 2016. Earlier, reporting on fraud on the company was restricted to fraud by officers or employees of a company. The revised clause requires an auditor to report whether any fraud by the company or any fraud on the company has been noticed or reported during the year. Accordingly, fraud on the company by any person would now be reported. In case a fraud has been noticed/reported, then an auditor is required to disclose the nature of fraud and the amount involved in its report.

*Meaning of fraud*

The term 'fraud' has been defined under Section 447 of the 2013 Act. In relation to the affairs of a company or body corporate, 'fraud' includes any act, omission, concealment of any fact or abuse of position committed by any person or any other person with the connivance in any manner, with the intent to deceive, to gain undue advantage from, or to injure the interests of, the company or its shareholders or its creditors or any other person, whether or not there is any wrongful gain or wrongful loss.

## Guidance by ICAI

### *Scope of reporting*

As per the guidance note, detection of fraud that have an intent to injure the interests of the company or cause wrongful gain or wrongful loss might not be possible for an auditor unless the financial effects of such acts are reflected in the books of account/ financial statements of the company. For instance, pay-offs received by an employee for favoring a specific vendor. However, an auditor is required to report all such instances noticed or reported to him/ her. The term 'noticed or reported' indicates that the management of the company should have the knowledge about the frauds on the company or by the company that have occurred during the period covered by the auditor's report.

Reporting would also cover frauds which may have an indirect impact on financial statements of the company.

### *Separate reporting on fraud 'on' or 'by' the company*

An auditor is required to report separately on the nature and amount involved with respect to:

- Fraud on the company i.e., fraud committed by the employees or third parties
- Fraud by the company i.e., fraud involving one or more members of management or those charged with governance.

### *Other considerations*

Two types of intentional misstatements that are relevant to the auditor's consideration of fraud are:

- *Misstatements resulting from fraudulent financial reporting:* It involves intentional misstatements or omissions of amounts/ disclosures in financial statements to deceive financial statement users
- *Misstatements resulting from misappropriation of assets:* It involves the theft of an entity's assets.

For the purpose of reporting, an auditor should inquire from the management about any frauds on the company that it has noticed or has been reported to it. The auditor should also discuss the matter with other employees including officers of the company. Further, an auditor would also examine the reports of the internal auditor and minutes of audit committee to ascertain whether any fraud has been reported or noticed. A written representation from management acknowledging its responsibility for the implementation and operation of accounting and internal control systems and the fact that disclosure of all significant facts relating to any frauds or suspected fraud has been made by the management should be obtained by an auditor.

## Filing of Form ADT-4

CARO 2020 has introduced a new reporting requirement wherein an auditor is required to state whether any report under Section 143(12) of the 2013 Act has been filed by the auditors in Form ADT-4 as prescribed under Rule 13 of the Companies (Audit and Auditors) Rules, 2014 (Audit Rules) with the Central Government (CG).

*Requirements of the 2013 Act*

Currently, Section 143(12) of the 2013 Act read with Rule 13 of the Audit Rules requires specific reporting by an auditor of a company in case of frauds. According to it, an auditor has to report a fraud committed in the company by its officers or employees involving an amount of INR1 crore or above to the CG in Form ADT-4 within 15 days from the date of receipt of reply or observations from the board of directors or audit committee.

In case fraud involves an amount less than INR1 crore, the matter needs to be reported to the audit committee or the board of directors of the company within two days of an auditor's knowledge of the fraud.

The reporting under Section 143(12) of the 2013 Act is also applicable to a cost auditor and secretarial auditor of a company.

### Guidance by ICAI

For the purpose of reporting, an auditor would need to consider the frauds reported by him/her under Section 143(12) of the 2013 Act during the year up to the date of its report. An auditor would also need to consider the report (in Form ADT-4), if any filed by the cost auditor or secretarial auditor of the company and should report it under this clause.

As per the guidance note, the reporting requirement would also be applicable in cases where the predecessor auditor of the company has reported under Section 143(12) of the 2013 Act during the year before the appointment of the successor auditor.

# Whistle-blower complaints

CARO 2020 has introduced a new reporting requirement which requires an auditor to consider whistle-blower complaints, if any, received by the company during the year under the audit.

*Existing frameworks*

Certain companies are required to maintain a vigil/whistle-blower mechanism under the relevant provisions of the 2013 Act and the Securities and Exchange Board of India (SEBI) (Listing Obligation and Disclosure Requirements) Regulations, 2015 (LODR). Those are as follows:

- **Mandatory vigil mechanism (Section 177 and Schedule IV of the 2013 Act):** Following class of companies are mandatorily required to establish a vigil mechanism for their directors and employees to report their genuine concerns or grievances:
  a. Listed companies
  b. Companies which accept deposits from the public
  c. Companies which have borrowed money from banks and public financial institutions in excess of INR50 crore.

Companies which are required to constitute an audit committee[16] should oversee the vigil mechanism through the committee. If any of the members of the committee have a conflict of interest in a given case, they should recuse themselves and the others on the committee would deal with the matter on hand. In case of other companies, the board of directors should nominate a director to play the role of audit committee for the purpose of vigil mechanism to whom other directors and employees may report their concerns. The vigil mechanism should provide for adequate safeguards against victimisation of employees and directors who avail of the vigil mechanism. In exceptional cases, it should also provide for direct access to the chairperson of the audit committee or the director nominated to play the role of audit committee, as the case may be.

Further, it is also the duty of an independent director of a company to ascertain and ensure that the company has an adequate and functional vigil mechanism and that the interests of a person who uses such mechanism are not prejudicially affected on account of its use.

- **Mandatory whistle-blower mechanism (Regulation 4(2)(d) of LODR):** Every listed company is required to devise an effective whistle-blower mechanism which would enable stakeholders, including individual employees and their representative bodies, to freely communicate their concerns about illegal or unethical practices
- **Disclosures (Regulation 46 and Schedule V of LODR/Section 177 of the 2013 Act):** The details of establishment of vigil mechanism/whistle-blower policy need to be disclosed by the companies on their websites and board's report. Listed companies are also required to disclose the details in the corporate governance report of their annual reports along with the affirmation that no personnel have been denied access to the audit committee.

16. Following companies are required to constitute an audit committee under the 2013 Act:
    a. Every listed public company
    b. An unlisted public company (except a joint venture, a wholly-owned subsidiary or a dormant company) which meets either of the following conditions:
       i. Its paid-up share capital is INR10 crore or more
       ii. It has a turnover of INR100 or more
       iii. Its aggregate outstanding loans, debentures and deposits exceeds INR50 crore.

## Guidance by ICAI

Reporting under this clause would cover:

- Whistle-blower complaints including anonymous complaints received by the company **during the year**; complaints pertaining to earlier years are not to be considered by an auditor
- Instances of frauds which have already been reported, identified/detected by the management or through the company's vigil/whistle-blower mechanism and has been/is being remediated/dealt with by them during the year.

Companies which are mandatorily required to establish the vigil/whistle-blower mechanism should ensure compliance with the provisions of the 2013 Act and LODR. In case of companies which are not mandatorily required to establish any vigil/whistle-blower mechanism and they did not establish such process voluntarily, then management of such companies would be required to provide all whistle-blower complaints to an auditor for review.

Further, to facilitate reporting, companies would need to devise appropriate mechanism such as ethics/whistle-blower/hotline process with adequate procedures which could handle anonymous complaints (received from inside and outside the company) and accept confidential submission of concerns about questionable accounting, internal control, or auditing matters. Auditors would also evaluate whether whistle-blower complaints are investigated and resolved by the company in an appropriate and timely manner.

# Unrecorded income disclosed in tax assessments

CARO 2020 has introduced a new reporting requirement wherein an auditor should report on whether there are any transactions which have not been recorded in the books of account of a company but have been surrendered or disclosed as income during the year in the tax assessments under the IT Act. If yes, then an auditor would also need to report whether the previously unrecorded income has been properly recorded in the books of account during the year.

### *Undisclosed income*

As per Section 158B of the IT Act, 'undisclosed income' includes any money, bullion, jewellery or other valuable article/thing or any income based on any entry in the books of account or other documents or transactions which represents wholly or partly income or property which has not been or would not have been disclosed for the purposes of IT Act. It also includes any expense, deduction or allowance claimed under the IT Act which is found to be false.

## Guidance by ICAI

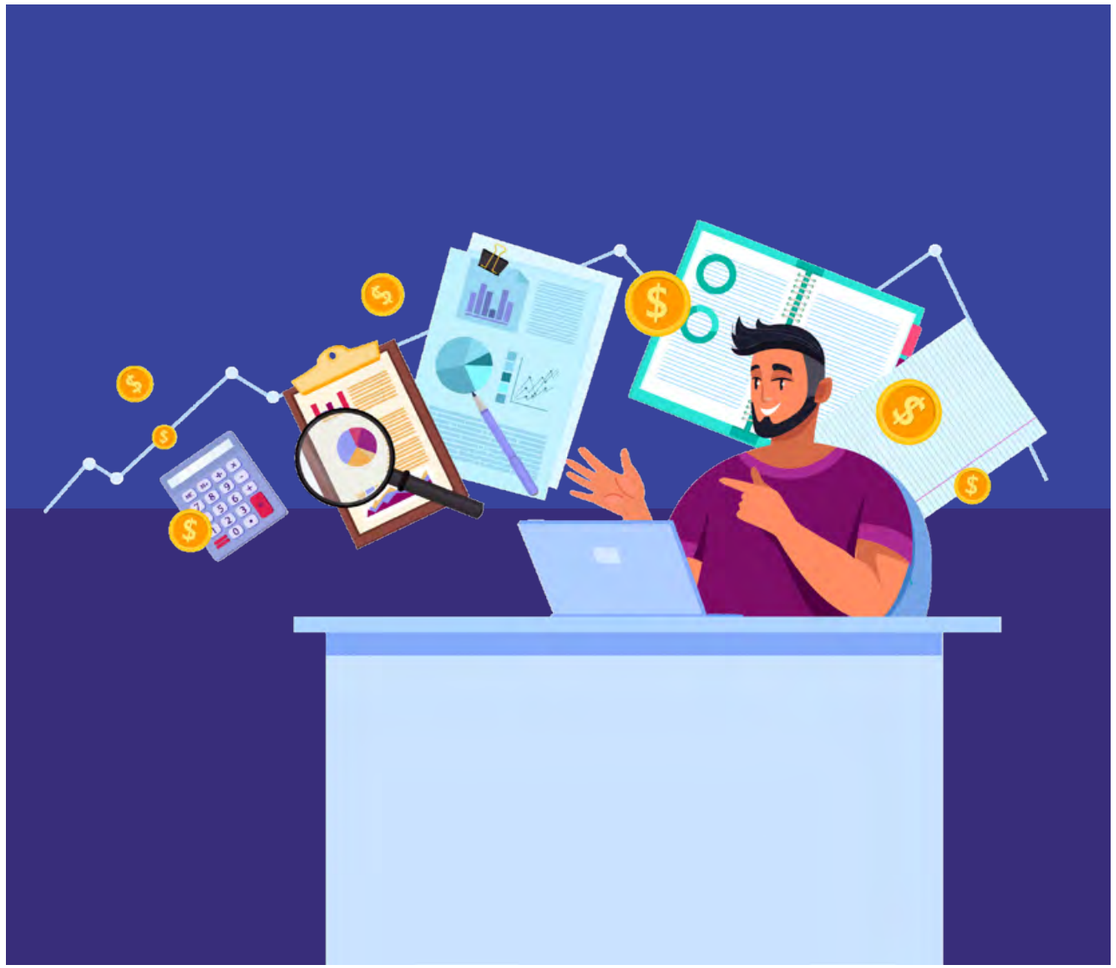
The term 'surrendered or disclosed' implies that the company must have voluntarily admitted to the addition of such income, which can be demonstrated on the basis of the returns filed by the company. Therefore, reporting under this clause would not cover situations, for instance, where additions have been made by income tax authorities and the company has disputed such additions or even where no appeal has been filed by the company in respect of the additions made by tax authorities.

The surrender or disclosure of unrecorded income might relate to any assessment year under the IT Act. Accordingly, for the purpose of reporting, an auditor would review the following:

- All tax assessments of a company completed during the year along with submission and statements filed by the company in the course of assessments
- Tax assessments which have been completed subsequent to the balance sheet date but prior to signing of the auditor's report, if the surrendered or disclosed income relates to the year under audit or prior years.

An auditor would also evaluate the effectiveness of internal financial controls of a company, in particular those relating to recognition of revenue/income.

Once such unrecorded transactions have been identified, an auditor would ascertain whether proper recording of such transactions has been duly made in the books of account. Proper recording includes proper disclosure in the financial statements of the company i.e., disclosure in the financial statements should be sufficient to enable users understand the impact of such transactions. The nature of disclosure would depend on the nature of undisclosed income and the treatment thereof if the same was duly disclosed and reported in the books of account in the year to which the undisclosed income relates to.



## Disclosures under Schedule III to the 2013 Act (New disclosure)

*Notes to the statement of profit and loss – Additional information*

A company is required to give details of any transaction not recorded in the books of accounts that has been surrendered or disclosed as income during the year in the tax assessments under the IT Act (such as, search or survey or any other relevant provisions of the IT Act), unless there is immunity for disclosure under any scheme. It shall also state whether the previously unrecorded income and related assets have been properly recorded in the books of account during the year.

# Qualifications in components' audit reports

CARO 2020 has introduced a new reporting requirement wherein an auditor is required to comment whether there have been any qualifications or adverse remarks in the CARO reports of the companies included in the CFS by the respective auditors. In case of qualifications/adverse remarks, an auditor is further required to provide the details of the companies and the paragraph numbers of the respective CARO report containing such qualifications or adverse remarks.

It is important to note that reporting requirements of CARO 2020 is not applicable on auditor's report on CFS, except reporting on qualifications for those entities included in CFS to whom CARO 2020 is applicable.

## Guidance by ICAI

Reporting under this clause would cover:

- All entities included in the CFS to whom CARO 2020 is applicable including parent company's standalone CARO report
- Every qualification/adverse remark made by an individual component including the parent.

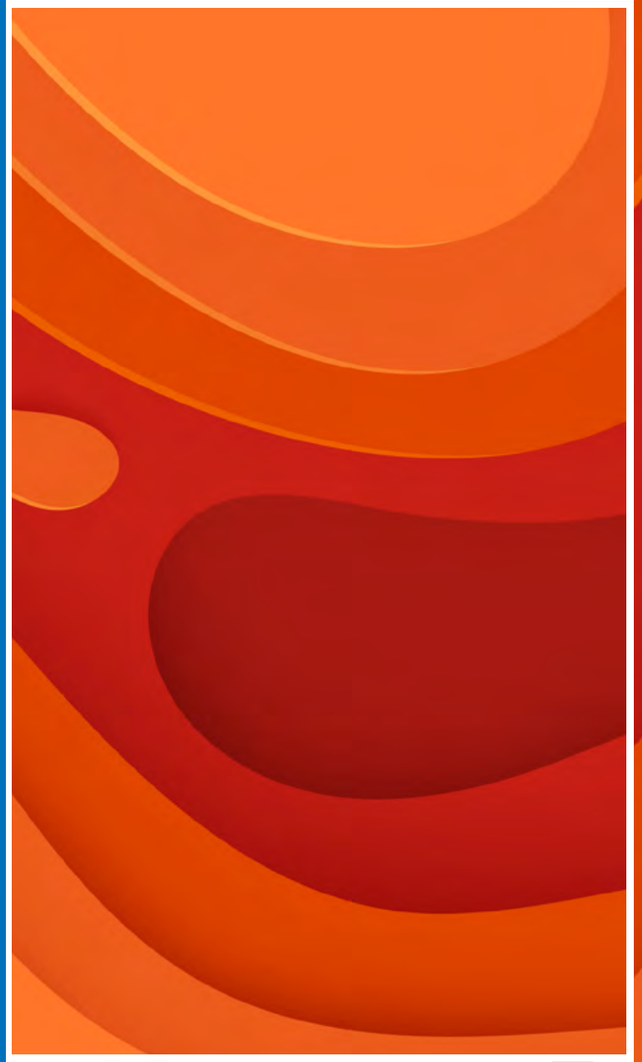
The responses to questions reported in CARO 2020 are responses to specific questions which are expected to be answered in affirmative or negative. Therefore, the term qualification/adverse remark used in the clause does not mean a qualification/adverse opinion as per principles enunciated in the Standard on Auditing (SA) 705 (Revised), *Modifications to the Opinion in the Independent Auditor's Report* which is issuance of an auditor's opinion on the financial statements as a whole. The principal auditor would need to apply professional experience and judgement while concluding whether the responses to various clauses are in the nature of qualifications or adverse remarks. For this purpose, inputs from component auditor could also be sought by the principal auditor.

In case where CARO report has not been issued by the component auditor by the date of principal auditor's report, the fact would be reported by the principal auditor along with the name of the component while reporting under this clause.

## Key considerations

Reporting of frauds by the company or on the company could be an indicator of internal control failures and inefficient business operations. With the enhanced scope of reporting, companies need to maintain adequate systems and controls, in particular those relating to financial reporting such that instances of fraud could be identified and addressed on a timely basis.

Additionally, companies should also consider evaluating its whistle-blower mechanism/vigil mechanism to ascertain whether such a mechanism is able to capture and address all genuine grievances. These would also be subject to review by an auditor under CARO 2020. Companies should also ensure proper recording of transactions disclosed or surrendered as income in the income-tax assessments as such transactions would also now be reported in the auditor's report under CARO 2020.

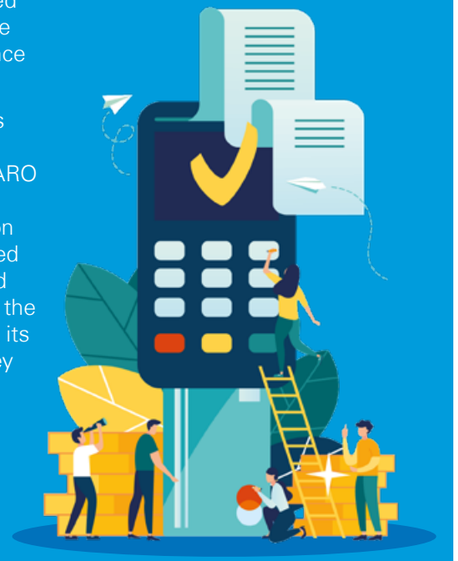


## CHAPTER 7

# Related party and non-cash transactions and material uncertainty

Companies enter into several transactions with various parties including related parties in the course of conduct of their business. However, high volume of transactions with related parties require an effective governance framework to avoid possible conflict of interests which could be detrimental to the affairs of a company. Moreover, if these transactions are not in compliance with the relevant provisions of the 2013 Act or LODR[17] (in case of a listed company), it could pose severe corporate governance implications for a company in addition to imposition of penal provisions. Additionally, the 2013 Act also restricts companies from incurring non-cash transactions with directors or persons connected with them. Reporting of compliances with these provisions in the auditor's report is expected to provide credibility to the operations and performance of a company.

Further, in order to assess and depict the liquidity position of a company, CARO 2020 requires an auditor to specifically comment on cash losses, if any, incurred by it in a financial year and material uncertainty as to the company's ability to meet its liabilities as and when they fall due.



17. SEBI (Listing Obligations and Disclosure Requirements) Regulations, 2015. On 9 November 2021, SEBI amended the LODR and made significant changes to the related party transactions provisions. These changes have not been covered in this chapter.

# Related Party Transactions (RPTs)

CARO 2020 requires an auditor to report on whether all transactions with the related parties are in compliance with Section 177 and 188 of the 2013 Act, where applicable. Also, an auditor is required to report whether the company has disclosed the details about such transactions in the financial statement, etc. as required by the applicable accounting standards (i.e., AS 18/Ind AS 24, *Related Party Disclosures).*

## Requirements of the 2013 Act

### Approval of RPTs by board of directors and shareholders

As per Section 188 of the 2013 Act, transactions with related parties that are not in the ordinary course of business and which are not at an arm's length would require consent of the board of directors of the company. Additionally, certain specified transactions would require prior shareholders' approval by an ordinary resolution. Those transactions are as follows:

| Prescribed transaction categories | Amount beyond which shareholder's approval is required |
|---|---|
| Sale, purchase or supply of any goods or materials (directly or through an agent) | Amounting to 10 per cent or more of the turnover of the company* |
| Selling or otherwise disposing of or buying property of any kind (directly or through an agent) | Amounting to 10 per cent or more of net worth of the company* |
| Leasing of property of any kind | Amounting to 10 per cent or more of the turnover of the company* |
| Availing or rendering of any services (directly or through an agent) | Amounting to 10 per cent or more of the turnover of the company* |

*(*Applies to transaction or transactions to be entered into either individually or taken together with the previous transactions during a financial year.)*

| Prescribed transaction categories | Amount beyond which shareholder's approval is required |
|---|---|
| Appointment to any office or place of profit in the company, subsidiary company or associate company | Remuneration exceeding INR2.5 lakh |
| Underwriting the subscription of any securities or derivatives of the company | Remuneration exceeding one per cent of the net worth |

*Source: KPMG in India's analysis, 2022 basis the provisions of Section 188 of the 2013 Act and Rule 15 of the Companies (Meetings of Board and its Powers) Rules, 2014*

### Approval of RPTs by an audit committee

All RPTs are also required to be approved by an audit committee as per the requirements of Section 177 of the 2013 Act. An audit committee can provide an omnibus approval for RPTs proposed to be entered into by the company subject to specified conditions. For transactions that are not covered under Section 188 of the 2013 Act, the audit committee can give recommendations to the board of directors, in case it does not approve the transaction.

Additionally, a transaction (involving an amount up to INR1 crore) is voidable at the option of the audit committee if it has been entered into by a director or officer of the company without its approval and has not been ratified by it within three months from the date of the transaction.

### Exemption from approval

Approval of shareholders and audit committee is not required for transactions entered into between a holding company and its wholly-owned subsidiary.

### Transactions entered into by a director or an employee

If a contract/arrangement/transaction has been entered into by a director or any other employee, without obtaining the consent of the board of directors, approval by a resolution or audit committee[18] and such a contract/arrangement/transaction has not been ratified by the board of directors/ shareholders/audit committee within three months from the date on which such contract/arrangement/transaction was entered into, then such contract/arrangement/transaction should be voidable at the option of the board of directors/ shareholders/audit committee, as the case may be.

### *Disclosures*

Every company is required to disclose in its board's report details of contracts or arrangements entered into by it with related parties in Form AOC-2. Form AOC-2 requires disclosure of:

- Contracts/arrangements/transactions entered by a company with related parties which are not at an arm's length basis and
- Material contracts/arrangement/transactions entered by a company with related parties at an arm's length basis.

Specific disclosures have also been prescribed under AS 18 and Ind AS 24. Those, inter alia, includes the following:

- Names of the related parties
- Relationships between a parent and its subsidiaries irrespective of whether there have been transactions between them
- Compensation to KMP (in total) and for each of the given categories:
  a. Short-term employee benefits
  b. Post-employment benefits
  c. Other long-term benefits
  d. Termination benefits and
  e. Share-based payment.
- If the company has had RPTs during the periods covered by the financial statements, it should disclose the nature of the related party relationship as well as information about those transactions and outstanding balances, including commitments necessary for users to understand the potential effect of the relationship on the financial statements.

  These disclosures should be made separately for the parent, subsidiary, associates, joint ventures, entities with joint control of, or significant influence over the entity, KMP and other related parties.

18. A transaction involving an amount up to INR1 crore is voidable at the option of an audit committee.

## Guidance by ICAI

### *Ordinary course of business*

The term 'ordinary course of business' has not been defined under the 2013 Act. As per the guidance note, it will cover the usual transactions, customs and practices of a business and a company. Some of the transactions which would be considered outside the company's normal course of business include:

- Complex equity transactions such as corporate restructurings or acquisitions
- Transactions with offshore entities in jurisdictions with weak corporate laws
- Sales transactions with unusually large discounts or returns
- Transactions under contracts whose terms are changed before expiry
- Leasing of premises or the rendering of management services by the entity to another party if no consideration is exchanged.

Accordingly, the assessment of whether a transaction is in the ordinary course of business is likely to be subjective, judgemental and will vary on a case-to-case basis.

### *Arm's length transaction*

While determining whether a transaction is at an arm's length or not, several factors would need to be considered by an auditor such as benefits/consideration for each of the parties to enter into the agreement, prevalent market/industry practice, economic circumstances, the specific contractual understanding and/or terms between the parties and similar contracts executed between other unrelated parties. An auditor may also test the transaction on the transfer pricing mechanism in use for the purposes of IT Act.

Companies would need to provide details of all their related parties and transactions entered into with them along with documentary proof as to the fact that the said transactions are on an arm's length basis to facilitate reporting under this clause by an auditor. An auditor may seek written representation in case of RPTs specifically approved by those charged with governance that materially affect the financial statements or involve management. Further, register of contracts/arrangements in which directors are interested maintained by the company under Section 189[19] of the 2013 Act and declarations made by the directors thereunder would also be evaluated by an auditor while reporting under this clause.

Companies should also provide adequate disclosures (laid down under AS 18/Ind AS 24, as applicable) with respect to the related parties and RPTs entered into by them as non-compliances with the disclosure requirements would be reported in the auditor's report.

# Non-cash transactions

An auditor is also required to report on whether the company has entered into any non-cash transactions with directors or persons connected with him/her. If yes, then an auditor is further required to comment on whether the provisions of Section 192 of the 2013 Act have been complied with.

## Requirements of the 2013 Act

A company is prohibited from entering into the following types of arrangements (under Section 192 of the 2013 Act):

a. An arrangement by which a director of the company or its holding, subsidiary or associate company or a person connected with such director acquires or is to acquire assets for consideration other than cash, from the company

b. An arrangement by which the company acquires or is to acquire assets for consideration other than cash, from such director or person so connected.

However, the arrangements are permissible if both the following conditions have been fulfilled by the company:

- Prior approval for such an arrangement has been taken through an ordinary resolution in the general meeting and
- If the concerned director or connected person is also a director of its holding company, similar approval has been obtained by the holding company through an ordinary resolution in its general meeting.

The notice for approval of the resolution by the company or holding company should include the particulars of the arrangement along with the value of the assets involved in such arrangement duly calculated by a registered valuer.

An arrangement entered into by a company or its holding company in contravention of these provisions would be voidable at the instance of the company unless:

a. The restitution of any money or other consideration which is the subject matter of the arrangement is no longer possible and the company has been indemnified by any other person for any loss or damage caused to it or

b. Any rights are acquired bona fide for value and without notice of the contravention by any other person.

19. Every company is required to maintain one or more registers in Form MBP 4 with particulars of:
    a. Company(ies) or bodies corporate, firms or other association of individuals, in which any director has any concern or interest
    b. Contracts or arrangements with a body corporate, firm or other entity in which any director is, directly or indirectly, concerned or interested and
    c. Contracts or arrangements with a related party with respect to transactions to which Section 188 applies.

## Guidance by ICAI

### *Non-cash transactions*

Transactions involving change in the assets or liabilities of a company but not involving 'cash' or 'cash equivalents' as defined under AS 3/Ind AS 7, *Cash Flow Statement* (as may be applicable), would be considered as non-cash transactions. For instance:

a. Acquisition of assets either by assuming directly related liabilities or by means of a finance lease

b. Acquisition of an entity by means of issue of shares

c. Conversion of debt to equity.

As per the guidance note, following transactions would not be considered as non-cash transactions:

- Where acquisition of an asset and the corresponding liability is created in the financial statements in a given year, however, the corresponding settlement is made in the following year
- Mergers under court schemes subject to requisite approvals of court.

### *Person connected with the director*

The term 'person connected with the director' has not been defined under the 2013 Act. As per the guidance note, reference should be made to the definition of 'any person in whom any of the director of the company is interested' under the 2013 Act for the purpose of reporting under this clause.

Those, *inter alia*, include:

a. Any private company of which any such director is a director or member or

b. Any body corporate at a general meeting of which not less than 25 per cent of the total voting power may be exercised or controlled by any such director, or by two or more such directors, together.

For the purpose of reporting under this clause, an auditor may seek following documents/records from a company:

- Form No. MBP 1, *Notice of interest by a director*
- Form No. MBP 2, *Register of loans, guarantee, security and acquisition made by the company*
- Form No. MBP 4, *Register of contracts with related party and contracts and bodies etc., in which directors are interested*
- Movements in the property, plant and equipment register
- Minutes of board and audit committee meetings
- Report on annual general meeting in Form No. MGT 15.

Management may also be asked to provide details of its intention to enter into transactions covered under Section 192 of the 2013 Act, after the date of the financial statements under audit.

# Cash losses

CARO 2020 has introduced a new reporting requirement which requires an auditor to comment on whether the company has incurred cash losses in the financial year (i.e., the period covered by the audit report) and in the immediately preceding financial year. If yes, then an auditor is further required to state the amount of cash losses for the period covered under audit and immediately preceding financial year.

## Guidance by ICAI

The term 'cash losses' is neither defined under the 2013 Act nor in the accounting standards. As per the guidance note, the term 'cash losses' needs to be distinguished from 'distributable surplus' and 'realised profits/losses'. Also, it may not be appropriate to consider cash flows from operating activities for the specific and limited purpose of this clause as items such as interest income/expense are also relevant for determination of cash losses.

Accordingly, following approach is suggested to compute the amount of cash losses:

- Amount of net Profit/Loss After Taxes (PLAT) (in case financial statements are prepared under AS)/profit or loss (excluding Other Comprehensive Income (OCI)) (in case financial statements are prepared under Ind AS) shown by the statement of profit and loss is adjusted for the effects of transactions of non-cash nature such as depreciation, amortisation and impairment loss or its reversal. No adjustment is required in respect of items of expenses of contingent nature such as claims not acknowledged as due by the company, etc.
- Cash profits/cash losses realised and recognised in OCI before their reclassification to statement of profit and loss, should be considered in determination of cash losses. However, its subsequent reclassifications into statement of profit and loss, being a non-cash adjustment, should not be considered
- In case of restatement of financial statements for the previous financial year as per Ind AS 8, *Accounting Policies, Changes in Accounting Estimates and Errors*, net PLAT determined after such restatement should be considered
- Cash losses of the company for the financial year covered by the audit report and the immediately preceding financial year should also be adjusted for the effect of qualifications in the respective audit reports to the extent the qualifications are quantified.

# Material uncertainty

Another newly introduced reporting requirement under CARO 2020 requires an auditor to comment on whether the auditor is of the opinion that no material uncertainty exists as on the date of the audit report about the company's capability 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. An auditor needs to form an opinion on the basis of the following:

- Financial ratios
- Ageing and expected dates of realisation of financial assets and payment of financial liabilities
- Other information accompanying the financial statements, for example, the director's report
- Auditor's knowledge of the board of directors and management plans.

## Guidance by ICAI

### *Financial assets and financial liabilities*

In the absence of definition of financial assets and financial liabilities under any other standard or the 2013 Act, the definitions as per Ind AS 32, *Financial Instruments: Presentation* may be considered for the purpose of reporting under this clause.

### *Company's ability to meet its liabilities*

An auditor is required to comment on the company's **ability** to meet 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. Accordingly, the liabilities should exist at the date of balance sheet which falls due within a period of one year from the balance sheet date. Also, 'liabilities falling due within a period of one year' and 'current liabilities' should not be construed as same.

For the purpose of reporting, an auditor would consider the guidance given in SA 570 (Revised), *Going Concern* and the related implementation guide to the extent relevant. Accordingly, if the main audit report contains a paragraph on 'material uncertainty related to going concern or key audit matter on going concern indicators', it would be duly considered by an auditor while putting a comment under this clause.

The test of existence of material uncertainty would be done as on the date of audit report for the position of liabilities existing at the date of balance sheet. Therefore, an auditor would also consider subsequent period transactions of a company between the date of balance sheet and the date of audit report while reporting under this clause.

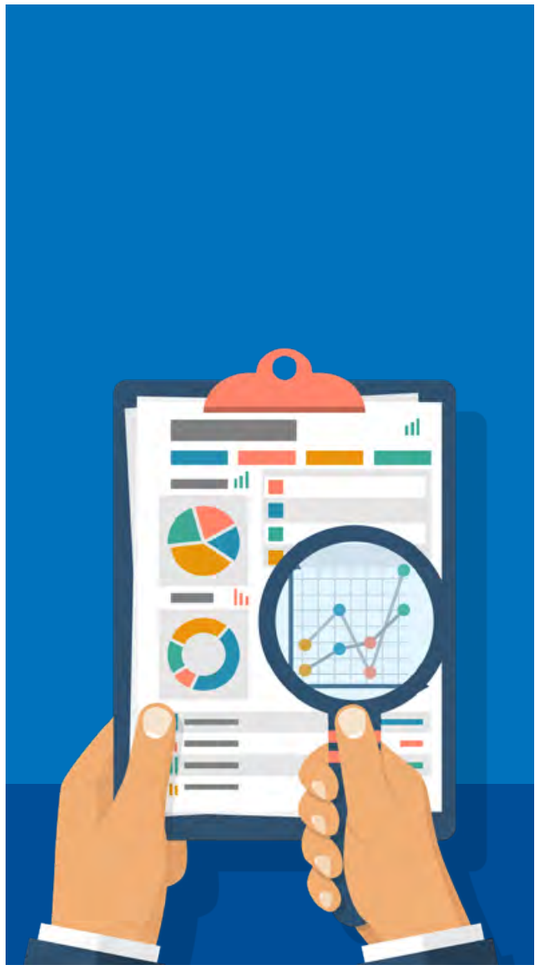
### *Basis of opinion*

The parameters prescribed under the clause i.e., financial ratios, ageing and expected dates of realisation of financial assets and financial liabilities, etc. appear to be inclusive. Accordingly, audit procedures based on these parameters would be performed by an auditor.

In order to facilitate reporting, companies would be required to provide details of liabilities existing at the date of balance sheet along with their due dates of payment as per the relevant agreements/ contracts along with the underlying documents. Subsequent payment status as on the date of audit report or date nearer to audit report, of liabilities those existed at the date of balance sheet would also be sought by an auditor to capture any material deviation as on the date of audit report.

Recoverability of financial assets would be tested on the basis of agreements/contracts, historical trends and the correspondence with the debtors and borrowers to assess whether those would be sufficient to meet the liabilities as and when they fall due for payment. A one-to-one relationship between the unpaid liabilities and the realisable financial assets is not required. The evaluation would be done on an overall basis by an auditor.

Further, financial position and plans of entities to whom the company has given commitments or guarantees on behalf of other entities including its subsidiaries, joint ventures and associates would also be evaluated to determine whether there would be an outflow of resources from the company which may impair its ability to meet its own liabilities.



# Disclosures under Schedule III to the 2013 Act (New disclosure)

*Notes to the balance sheet – Additional regulatory information*

The amendments require companies to make following disclosures in the notes to the balance sheet:

(a) Current ratio,

(b) Debt-equity ratio,

(c) Debt service coverage ratio,

(d) Return on equity ratio,

(e) Inventory turnover ratio,

(f) Trade receivables turnover ratio,

(g) Trade payables turnover ratio,

(h) Net capital turnover ratio,

(i) Net profit ratio,

(j) Return on capital employed,

(k) Return on investment.

Companies should also explain the items included in numerator and denominator for computing the above ratios. Further, explanation shall be provided for any change in the ratio by more than 25 per cent as compared to the preceding year.

## Key considerations

Companies should maintain sufficient systems to trace all its related parties in accordance with the requirements of the 2013 Act with detailed policies/contracts/ arrangements so as to confirm that the transactions held with them were in the normal course of business and at an arm's length basis. Separate records would be required for any kind of arrangement under which it ought to acquire any asset other than cash along with necessary approvals.

Additional records to substantiate its ability to meet liabilities as and when they fall due need to be maintained by a company for an auditor to verify e.g., cash flow projections for the future period of 12 months from the date of balance sheet.

Disclosure of ratios by companies would also be subject to audit by an auditor as part of the financial statements. The ratios would need to be well-defined (including sector specific ratios) and the method of computation should be consistent year on year.

## CHAPTER 8

# Unspent CSR amount, internal audit system and resignation of a statutory auditor

Corporate Social Responsibility (CSR) activities play a significant role in the nation building. Currently, the 2013 Act governs the framework of CSR for companies in India. As per the framework, companies meeting prescribed criteria[20] are mandatorily required to contribute two per cent of their profits for the purpose of CSR in accordance with the provisions of the 2013 Act. Schedule VII to the 2013 Act prescribes eligible activities which can be covered in CSR policy by companies. From the time CSR provisions have been made effective[21], have been significantly amended by MCA to streamline its implementation by companies. On 22 January 2021, the MCA made utilisation of unspent amount earmarked for CSR activities mandatory for companies, failing which it would be transferred to the funds specified in the Schedule VII to the 2013 Act. To assess whether these provisions are being followed in spirit, an auditor of a company is required to report on the treatment of unspent CSR amount in its report under the CARO 2020.

In the rapidly changing business environment, companies need to be agile and adopt business practices that can address the potential risks (e.g., fraud risk, liquidity risk, reputational risk, etc.) and resultant uncertainty. For timely addressal of such risks and to assess operating effectiveness and efficiency of a company, internal audit system is being deployed by the management which forms an integral part of the company's risk management system. Internal audits are not restricted to financial reporting areas, they penetrate deep into the operational and other related aspects of a company. In general, an internal audit function includes evaluation of internal controls, risk management and governance practices, review of operating activities and review of compliance with laws and regulations. Listed and specified unlisted companies are mandatorily required to appoint an internal auditor for conducting the internal audit in accordance with the requirements of the 2013 Act. The auditor would also now be required to report on adequacy of the internal audit system of a company in its report under CARO 2020.

Auditor resignation has been an area of focus for regulators in the recent times. While an auditor is required to comply with the prescribed procedure under the 2013 Act when it resigns from a company, SEBI too has laid down guidelines for listed companies (including their material subsidiaries) to disclose detailed reasons for resignation by their statutory auditors to the stock exchanges as soon as possible. The auditor would now be required to report on the resignation of the statutory auditor, if any, during the year along with affirming that the issues, objections or concerns raised by the outgoing auditor have been duly considered by the incoming auditor.

# Unspent CSR amount

Pursuant to the amendments made by MCA to Section 135 of the 2013 Act and the Companies (CSR Policy) Rules, 2014, CARO 2020 has introduced new reporting requirements wherein an auditor is required to comment on the following:

- **In case of ongoing projects:** Whether the company has transferred the unspent CSR amount to a special account in compliance with the provisions of Section 135(6) of the 2013 Act.
- **In case of projects other than ongoing:** Whether the company has transferred the unspent CSR amount to a fund specified in Schedule VII to the 2013 Act within a period of six months of the expiry of the FY in compliance with the provisions of Section 135(5) of the 2013 Act.

20. Every company with a net worth of INR500 crore or more, turnover of INR1,000 crore or more or a net profit of INR5 crore or more during the immediately preceding Financial Year (FY) should contribute at least two per cent of its average net profits (made during the three immediately preceding FYs) for the purpose of CSR pursuant to its policy in this regard. (Section 135 of the 2013 Act).
21. CSR provisions became effective from 1 April 2014.

# Disclosures under Schedule III to the 2013 Act (New disclosure)

*Notes to the statement of profit and loss*

Where the company is covered under Section 135 of the 2013 Act, the following shall be disclosed with regard to CSR activities:

a. Amount required to be spent by the company during the year

b. Amount of expenditure incurred

c. Shortfall at the end of the year

d. Total of previous years shortfall

e. Reason for shortfall

f. Nature of CSR activities

g. Details of RPTs, e.g. contribution to a trust controlled by the company in relation to CSR expenditure as per relevant AS/Ind AS

h. Where a provision is made with respect to a liability incurred by entering into a contractual obligation, the movements in the provision during the year shall be shown separately.

## Requirements of the 2013 Act

### *Ongoing projects*

As per the amendments, in case the CSR amount remains unspent pursuant to any ongoing CSR project undertaken by a company as per its CSR policy, then the company should transfer such unspent amount to a special account (named 'unspent CSR account') within a period of 30 days from the end of the financial year (FY). The company should spend the amount transferred to the unspent CSR account within a period of three FYs from the date of such transfer as per its obligation towards the CSR policy.

In case it fails to spend the amount within the specified period, it would be required to transfer the same to a fund specified in Schedule VII of the 2013 Act, within a period of 30 days from the date of completion of the third FY.

### *Other than ongoing projects*

In other cases, the unspent amount is required to be transferred to a fund specified in Schedule VII of the 2013 Act within a period of six months from the expiry of the FY.

## Guidance by ICAI

In accordance with the FAQ[22] issued by ICAI in May 2021, CSR expenditure would be recognised as an expense in the statement of profit and loss as and when such expenditure is incurred on the CSR activities undertaken as per the board approved CSR policy and CSR projects during the financial year.

For the 'unspent amount', a legal obligation arises to transfer to specified accounts depending upon the fact whether such unspent amount relates to ongoing projects or not. Therefore, a liability needs to be recognised for such 'unspent amount' as at the end of the financial year as per para 17(a) of Ind AS 37, *Provisions, Contingent Liabilities and Contingent Assets*.

An auditor would verify the provision for the unspent amount created by a company for the purpose of reporting under this clause.

To facilitate reporting, a company would be required to provide the following to its auditor:

a. Board approval of CSR policy as recommended by CSR committee

b. Agenda and minutes of meetings of CSR committee

c. The workings of the amount required to be spent under Section 135 of the 2013 Act along with detailed calculations of the average net profits as per Section 198 of the 2013 Act.

d. Details of amount spent on CSR activities along with supporting documents such as expenditure receipts, bank statements, etc.

In case of ongoing projects, an auditor may also verify that the amount transferred to the specified bank account has been utilised for the CSR activities as per CSR policy within three years from the date of such transfer. Additionally, an auditor would evaluate if the company has considered disclosure of such unspent amounts as commitments in the contingent liabilities and commitments section of the financial statements in accordance with the requirements of Schedule III to the 2013 Act.

If a company fails to transfer the unspent amount within the stipulated period and as on the date of auditor's report, it would be reported in the auditor's report. Non-compliances in respect of earlier financial year(s), if any, would also be reported.

22. Frequently Asked Question (FAQ) on Accounting for amounts to be incurred towards CSR pursuant to the Companies (CSR Policy) Amendment Rules, 2021

# Internal audit systems

Another new reporting requirement introduced by CARO 2020 requires an auditor to comment on whether the company has an internal audit system commensurate with the size and nature of its business.

Additionally, an auditor is required to comment on whether it has considered the reports of the internal auditors for the period under audit.

## Requirements of the 2013 Act

Following companies are mandatorily required to appoint an internal auditor in accordance with the provisions of Section 138 of the 2013 Act:

- Listed company
- An unlisted public company meeting either of the following criteria during the preceding FY:
  - i. Paid up share capital of INR50 crore or more
  - ii. Turnover of INR200 crore or more
  - iii. Outstanding loans or borrowings from banks or public financial institutions exceeding INR100 crore or more at any point of time or
  - iv. Outstanding deposits of INR25 crore or more at any point of time.
- A private company with turnover of INR200 crore or more or outstanding loans or borrowings from banks or public financial institutions exceeding INR100 crore or more at any point of time during the preceding FY.

An internal auditor may be an individual, a partnership firm or a body corporate. An internal auditor may or may not be an employee of the company. The audit committee of the company or the board of directors should formulate the scope, functioning, periodicity and methodology for conducting the internal audit, in consultation with the internal auditor.

## Guidance by ICAI

As per the guidance note, for the purpose of determining applicability of internal audit norms in case of a listed company, the company should be listed as on the date of the balance sheet.

For the purpose of reporting under this clause, an auditor would evaluate the following:

- **Size of the internal audit department:** This would involve consideration of nature of the business of the company, the number of operating locations, extent to which internal controls are decentralised and the effectiveness of other forms of internal control.
- **Qualifications of the persons who undertake the internal audit work:** This would include assessment of number of qualified personnel including assessment of competency, objectivity and the independence of external agencies, if appointed.
- **Reporting responsibility of the internal auditor:** Under the 2013 Act, an internal auditor is required to report to the board of directors or the audit committee. In case of a listed company, an audit committee is designated with review of the adequacy of internal audit function, reporting structure coverage and frequency of internal audit and is also obliged to review the performance of internal auditors in accordance with the provisions of the LODR. Compliance with the provisions of the 2013 Act and LODR would be verified by an auditor.
- **Adequate follow-up system:** An internal audit system should not only point out errors in operation or deficiencies in the internal control system. Additionally, there should be an adequate follow-up system to ensure that the deficiencies pointed out are corrected and remedial action taken on the deficiencies reported upon.

Inquiries and reporting regarding the existence of internal audit system would also be made in respect of companies which are not mandatorily required to appoint an internal auditor.

*Internal audit reports*

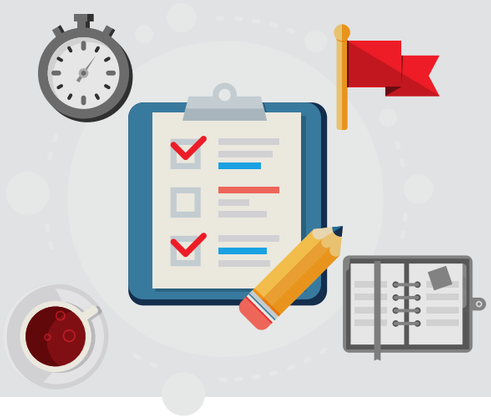
For the purpose of reporting, internal audit reports covering period up to the end of the FY under audit would be considered by an auditor prior to finalising the auditor's report (including its report on internal financial controls over financial reporting).

Management should discuss and ensure that the internal audit is completed as per the plan and the periodic reports of the internal auditors are made available sufficiently in advance for statutory auditor to review and assess the impact of the internal audit observations. The reports would include draft audit reports together with annexures and not merely the executive summary/power point presentations.

### Guidance by ICAI

Where some or all internal audit reports are not available, reports are provided at very short notice or they do not adequately address the plan and scope required, the statutory auditor would consider appropriate reporting in this clause as well as consider its effect on the overall control environment with regard to reporting on internal financial controls over financial reporting.

An auditor may also hold meeting with the internal auditor to discuss the findings and observations of the internal auditor in order to independently evaluate the impact of the observations on the financial statements.



# Resignation of a statutory auditor

CARO 2020 has introduced a new reporting requirement wherein an auditor is required to report if there has been any resignation of the statutory auditors during the year. If yes, then it further requires an auditor to consider the issues, objections or concerns raised by the outgoing auditors.

## Requirements of the 2013 Act and LODR

An auditor who has resigned from the company is required to file a statement in Form No. ADT-3, *Notice of Resignation by the Auditor* indicating the reasons and other facts as may be relevant with regard to his/her resignation with the company and the Registrar of Companies (ROC) within a period of 30 days from the date of resignation.

On the other hand, listed companies are required to obtain information from the auditor *vis-à-vis* detailed reasons for resignation, whether the inability to obtain sufficient appropriate audit evidence was due to a management-imposed limitation and whether the lack of information was prevalent in the previous reported financial statements/results. These are to be disclosed to the stock exchanges as soon as possible but not later than 24 hours of receipt of such reasons from the auditor.

### Guidance by ICAI

Reporting under this clause is applicable where a new auditor (incoming auditor) is appointed during the year to fill a casual vacancy caused by resignation of the auditor created in the office of the previous auditor under Section 140(2) of the 2013 Act. Reporting is not applicable in case of change of auditors on account of mandatory rotation requirements as prescribed under the 2013 Act.

The auditor is expected to describe the circumstances while giving the reasons for resignation suitably, instead of mentioning ambiguous reasons such as other preoccupation or personal reasons. The incoming auditor will obtain the copy of letter of resignation stating the reasons as submitted to the management and Form ADT-3 submitted with ROC. Additionally, it will inquire from the management and will go through the communication made to audit committee (i.e., audit committee presentation) to determine if there is any matter communicated to those charged with governance.

# Key considerations

The new reporting requirements cast additional responsibilities on the management, in particular those relating to appropriate treatment of unspent CSR amount and maintenance of adequate and effective internal audit system.

Companies would need to devise suitable internal audit system covering its diverse operation, not merely financial aspects to facilitate reporting by an auditor. It could also have an impact on the reporting on company's internal controls over financial reporting. It would be challenging for an auditor to determine the adequacy of the company's internal audit system *vis-à-vis* the size and nature of its business. Factors highlighted by ICAI in its guidance note such as qualifications of persons, follow-up system, etc. would help in such an evaluation.

## CHAPTER 9

# Utilisation of money raised through an IPO and private placement of shares and debentures

In order to expand the capital base and to meet the business needs, companies, in general, raise funds by going public. In India, companies can raise funds through different modes such as making an Initial Public offer (IPO), Further Public Offer (FPO), private placement and preferential issue to name a few. Such issues are governed by the provisions of the 2013 Act and the relevant regulations issued by SEBI which a company is required to comply with.

Compliance with the prescribed provisions by a company would be reported in the auditor's report in accordance with CARO 2020. Additionally, the report would also highlight instances where the funds so raised have not been utilised for the stated purpose by the company.

# Utilisation of money raised through an IPO or FPO

Similar to CARO 2016, CARO 2020 requires an auditor to comment on whether money raised by way of an IPO or FPO (including debt instruments) during the year were applied for the purposes for which those are raised. If not, then an auditor should furnish the details together with delays or default and subsequent rectification, if any, as may be applicable.

## Current regulatory framework

### 2013 Act

Currently, there is no legal requirement under the 2013 Act to disclose the end use of money raised by an IPO or FPO (including debt instruments) in the financial statements. Schedule III to the 2013 Act requires that only unutilised amount of any IPO or FPO (including debt instruments) made by the company should be disclosed in the financial statements of a company.

### SEBI Regulations

In addition to the requirements of the 2013 Act, companies raising money by way of an IPO or FPO are required to follow the requirements of the relevant SEBI regulations. In this context, SEBI (Issue of Capital and Disclosure Requirements) Regulations, 2018 (ICDR Regulations) prescribe detailed guidelines for public issue i.e., an IPO and FPO (including an offer for sale).

As per the guidelines, an IPO or FPO would cover issue of equity shares, convertible securities, non-convertible debt securities, non-convertible redeemable preference shares, perpetual debt instruments, perpetual non-cumulative preference shares, Indian Depository Receipts (IDRs) and securitised debt instruments. Utilisation of issue proceeds are to be disclosed in the offer document submitted to the stock exchanges.

Additionally, LODR prescribe disclosures to be made by a company making a public issue. According to it, certain statement(s) should be submitted by a company making public issue to the stock exchange on a quarterly basis till the time issue proceeds have been fully utilised or the purpose for which these proceeds were raised has been achieved. Those statements are as follows:

- Deviations, if any, in the use of proceeds from the objects stated in the offer document or explanatory statement to the notice for the general meeting, as applicable
- Category wise variation (capital expenditure, sales and marketing, working capital, etc.) between projected utilisation of funds made by it in its offer document or explanatory statement to the notice for the general meeting, as applicable and the actual utilisation of funds.

The listed company is also required to prepare an annual statement of funds utilised for purposes other than those stated in the offer document/ prospectus/notice, which is to be certified by its statutory auditors. The statements should be placed before the audit committee till such time the full money raised through the issue has been fully utilised. Further, where the listed company has appointed a monitoring agency to monitor the utilisation of proceeds of a public or rights issue, the monitoring report of such an agency is placed before the audit committee on an annual basis, promptly upon its receipt.

## Guidance by ICAI

In the absence of any legal requirement, companies should disclose the end use of money raised through an IPO or FPO (including debt instruments) in the financial statements by way of notes. The disclosure would be verified by an auditor for the purpose of reporting under this clause.

Reporting under this clause would not cover:

- Offer for sale of specified securities (i.e., equity shares and convertible securities) to the public by any existing holder
- Money raised from foreign capital markets in any form and by way of issuance of Global Depository Receipts (GDRs) and American Depository Receipts (ADRs).

As per the guidance note, a one-to-one relationship with the amount of money raised by way of an IPO or FPO (including debt instruments) and its utilisation is not required. In case the money raised has not been applied for the stated purpose during the year on account of being raised at the fag-end of the year, the fact would be reported in the auditor's report. Therefore, while reporting for the current accounting period, an auditor would consider the utilisation of amounts raised in the previous accounting period and would report accordingly.

In case a company fails to apply the amount of money raised through an IPO and FPO for the stated purpose, the fact would be reported in the auditor's report along with the following:

- Amount involved
- Nature of default
- Delay in utilisation and
- Details of any subsequent rectifications made by the company.

# Preferential allotment or private placement of shares or debentures

CARO 2020 has slightly modified the requirement relating to preferential allotment of shares or debentures *vis-à-vis* CARO 2016. In accordance with the modified requirement, an auditor is required to report on whether the company has made any preferential allotment or private placement of shares or convertible debentures **(fully, partially or optionally convertible)** during the year. If yes, it further requires reporting on the following:

- Whether the company was in compliance with the requirements of Section 42 and **Section 62** of the 2013 Act.
- **Funds** raised have been used for the purposes for which the funds were raised. If not, details of amount involved and nature of non-compliance to be reported.

*(Emphasis added to highlight the additions made vis-à-vis CARO 2016)*

## Requirements of the 2013 Act

### *Private placement*

As per Section 42 of the 2013 Act, a company authorised by a special resolution can make a private placement of securities to a select group of persons identified by its board excluding the qualified institutional buyers and employees of the company being offered securities under a scheme of employees stock option.

A company undertaking a private placement is required to issue a private placement offer and an application to identified persons whose names are recorded by the company. Further, a company cannot utilise monies raised through the private placement unless allotment is made, and the return of allotment is filed with the Registrar of Companies (ROC) in Form PAS-3 within 15 days from the date of allotment. The securities should be allotted within 60 days of the receipt of application money for such securities by the company. If the company is not able to allot the securities within that period, it should repay the application money to the subscribers within 15 days from the expiry of 60 days. Failure to repay the application money would attract payment of the amount with interest (at the rate of 12 per cent from the expiry of the 60th day).

Additionally, a company can utilise the application money received only for the following purpose:

- For adjustment against allotment of securities or
- For the repayment of monies where the company is unable to allot securities.

### *Preferential allotment*

The term 'preferential allotment' has not been defined under the 2013 Act. However, Section 62(1)(c) of the 2013 Act read with Rule 13 of the Companies (Share Capital and Debentures) Rules, 2014 allows a company authorised by a special resolution to increase its subscribed capital by further issue of shares or other securities (i.e., equity shares, fully or partly convertible debentures or other securities convertible or exchanged with equity shares at a later date) through a preferential offer to a select person or group of persons. The shares can be issued either for cash or for a consideration other than cash, if the price of such shares is determined by the valuation report of a registered valuer. Price of shares to be issued on a preferential basis by a listed company is not required to be determined by the valuation report of a registered valuer.

Listed companies are additionally required to comply with the relevant provisions of the SEBI regulations i.e., ICDR Regulations and LODR.

Companies making preferential offer are required to disclose certain details about the offer in the explanatory statement to be annexed to the notice of general meeting such as objects of the issue, total number of shares to be issued, class of persons to whom allotment is proposed to be made and change in control, if any, in the company that would occur consequent to the preferential offer. Further, the allotment of securities on a preferential basis should be completed within a period of 12 months from the date of passing of the special resolution.

## Guidance by ICAI

Companies are expected to ensure compliance with the requirements of the 2013 Act and SEBI Regulations while issuing shares or securities on a private placement or preferential basis. In order to assess whether the company has applied the funds so raised for the purpose for which these securities were issued, following documents would be verified by an auditor:

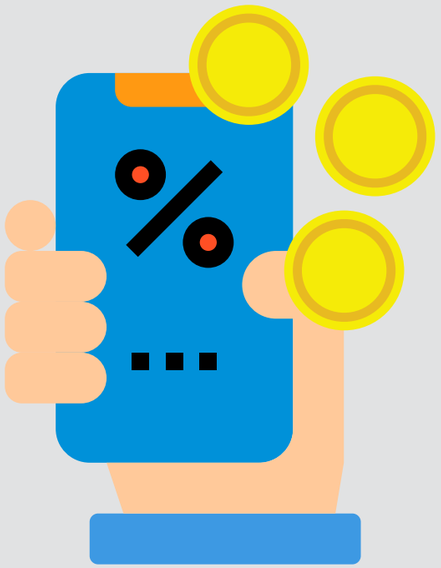
- Form PAS-4, *Private Placement Offer Letter*
- Explanatory statement annexed to the notice of general meeting authorising such issue.

As per the guidance note, one-to-one relationship with the amount of money raised through a private placement or on a preferential basis and its utilisation is not required. In case the funds have been temporarily invested for other business reasons, then this fact would be reported in the auditor's report.

If the funds have not been applied by the company during the year on account of being raised at the fag-end of the year, this fact would be reported in the auditor's report. Accordingly, while reporting for the current accounting period, an auditor would consider the utilisation of amounts raised in the previous accounting period and would report accordingly.

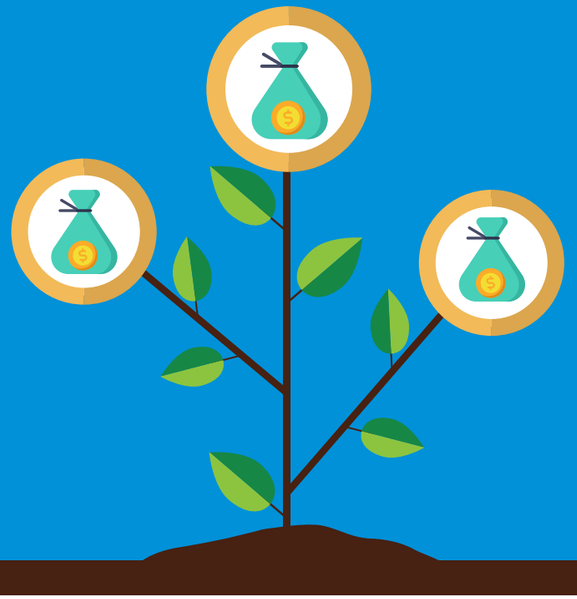
In case the company does not utilise the funds for the purpose they were raised, the same would be reported in the auditor's report along with the following details:

- Amount involved
- Nature of default/non-compliance
- Delay in utilisation



## Key considerations

An auditor's comment on the end use of money raised through an IPO, FPO, private placement or preferential issue in its report will provide additional credibility to a company and would also assist lenders to assess the governance aspects of a company along with its credit standing. Companies on the other hand need to ensure compliance with the requirements of the 2013 Act and relevant SEBI Regulations *vis-à-vis* such issues including documentation and filing of forms with the relevant authorities.



# CHAPTER 10

# Others

# Conduct of a business and registration as an NBFC, HFC and/or CIC and compliances by a Nidhi company

The rise in the corporate failures and operations of companies without obtaining necessary registration or approvals led to a significant decline in the market confidence. Therefore, it becomes imperative to impose restrictions on companies which are required to obtain prior approval to conduct their business operations. NBFCs and Housing Finance Companies (HFCs) are examples of such companies which forms core of the India's lending system and are therefore, governed by the apex body of banks and financial institutions - RBI. These companies are required to obtain a certificate of registration from the RBI before engaging in the business of Non-Banking Financial Institution (NBFI) or housing finance.

With a view to ensure greater scrutiny and transparency in operation of such companies, CARO 2020 requires an auditor to report instances where such businesses are not operated in accordance with the prescribed guidelines including not obtaining valid certificate of registration. Similar comments are required to be made in the auditor's report of companies engaged in acquisition of shares and securities and operating as Core Investment Companies (CICs).

# Conduct of business by NBFCs and HFCs without valid registration

CARO 2020 has enhanced the reporting requirements relating to NBFCs and HFCs *vis-à-vis* CARO 2016. As per the requirements, an auditor is required to comment on whether the company is required to be registered under Section 45-IA of the RBI Act, 1934 (RBI Act). If yes, then auditor should further comment on whether the registration has been obtained by the company.

Additionally, an auditor is required to report on whether the company has conducted any non-banking financial or housing finance activities without a valid Certificate of Registration (CoR) from the RBI as per the RBI Act.

## Requirements of the RBI Act

### NBFCs

In terms of Section 45-IA of the RBI Act, it is mandatory for a company to obtain CoR from RBI before commencing or to carry on business of a NBFC with financing activity as its principal business. Additionally, it should have a minimum net owned fund of INR2 crore.

**Financial activity as a principal business**

A company has financial activity as its principal business when it meets both the following criteria:

- Its financial assets constitute more than 50 per cent of the total assets and
- Its income from financial assets constitute more than 50 per cent of the gross income.

Therefore, companies predominantly engaged in financial activity are required to be registered with RBI as NBFCs.

### HFCs

HFC means a company incorporated under the 2013 Act that meets both the following conditions[23]:

a. It is an NBFC whose financial assets, in the business of providing finance for housing, constitute at least 60 per cent of its total assets (netted off by intangible assets).

b. Out of the total assets (netted off by intangible assets), not less than 50 per cent should be by way of housing financing for individuals.

Additionally, a company is required to obtain a CoR from RBI and should have a minimum net owned fund of INR20 crore to commence or carry on housing finance as its principle business.

23. RBI issued a revised regulatory framework for HFCs applicable from 22 October 2020 vide its notification no. RBI/2020-21/60 dated 22 October 2020. RBI also prescribes a timeline for transition to the given thresholds by the registered HFCs in the notification.

## Guidance by ICAI

For the purpose of reporting under this clause, an auditor would examine the transactions of the company with relation to the activities covered under the RBI Act and directions relating to the NBFCs and HFCs. This would also involve examination of financial statements of a company to determine the thresholds specified for registration as NBFCs and HFCs with respect to financial assets, income from financial assets and total assets, as the case may be. Additionally, verification of a company's net owned fund would be done by an auditor. In case of any breach in the limits due to certain specific transactions/event, a company is required to communicate the same to the RBI and disclose this fact in the financial statements. An auditor would also consider these facts while reporting under this clause.

Management will also have to furnish a written representation in case the CoR has been withdrawn/revoked/suspended/surrendered during the period and as to whether business has been continued after such withdrawal/ revocation/suspension/surrender.

In case a company conducts its business without holding a valid CoR, then it would be reported by an auditor in the auditor's report along with the reasons, if any, for not obtaining registration.

# Conduct of business as a CIC

CARO 2020 has introduced certain new reporting requirements relating to the conduct of a business as a CIC. As per the requirements, an auditor is required to examine whether the company is engaged in the business which attracts the requirement of registration as a CIC. If yes, it requires an auditor to comment on:

a. Whether the company continues to fulfil the criteria of a CIC

b. In case the company is an exempted or unregistered CIC, whether it continues to fulfil such criteria.

Additionally, in case a group has more than one CIC, then an auditor is required to indicate the number of CICs in the auditor's report.

### Eligibility for conduct of a business as CIC

RBI defines CIC as an NBFC company which carries on the business of acquisition of shares and securities and which satisfies the following conditions as on the date of the last audited balance sheet[24]:

a. It holds not less than 90 per cent of its net assets in the form of investment in equity shares, preference shares, bonds, debentures, debt or loans in group companies

b. Its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies and units of Infrastructure Investment Trust (InvIT) only as a sponsor constitute not less than 60 per cent of its net assets

c. It does not trade in its investments in shares, bonds, debentures, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment

d. It does not carry on any other financial activity referred in Section 45I(c) and 45I(f) of the RBI Act except:

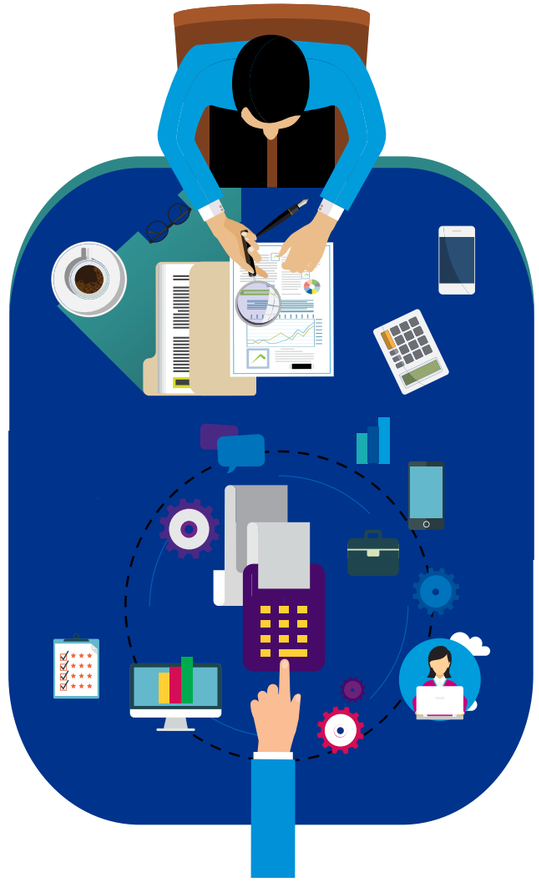
   i. Investment in bank deposits, money market instruments, government securities and bonds or debentures issued by group companies

   ii. Granting of loans to group companies and

   iii. Issuing guarantees on behalf of group companies.

e. Its asset size is INR100 crore or above either individually or in aggregate along with other CICs in the group and

f. It raises or holds public funds.



24. Master Direction - Core Investment Companies (Reserve Bank) Directions, 2016 issued by RBI updated as on 5 October 2020.

### Registration of a CIC

Every CIC is required to apply to RBI for grant of CoR within a period of three months from the date of becoming a CIC. However, following companies are not required to register with RBI and thus, are termed as 'unregistered CICs':

a. CICs with an asset size of less than INR100 crore, irrespective of whether accessing public funds or not and

b. CICs with an asset size of INR100 crore and above and not accessing public funds.

Further, unregistered CICs with asset size above INR100 crore and accessing public funds without obtaining a CoR from RBI would be violating CIC (Reserve Bank) Directions, 2016.

All CICs, in particular unregistered CICs must ensure that they can meet the obligations if undertaken on behalf of their group entities, as and when they arise, for instance, issue of guarantee or taking other contingent liabilities, without recourse to public funds in the event the liability devolves. Else, they would require registration with RBI to access public funds.

Additionally, CICs which are presently exempted from the regulatory framework of RBI (exempted CICs) but intend to undertake overseas investment in the financial sector would be required to register themselves with RBI and would be regulated like Systemically Important Core Investment Company (CIC-ND-SI).

### Companies in a group

Companies in a group mean an arrangement involving two or more entities related to each other through any of the following relationships:

a. Subsidiary-parent

b. Joint venture

c. Associate

d. Promoter-promotee for listed companies

e. Related party

f. Common brand name

g. Investment in equity shares of 20 per cent and above.

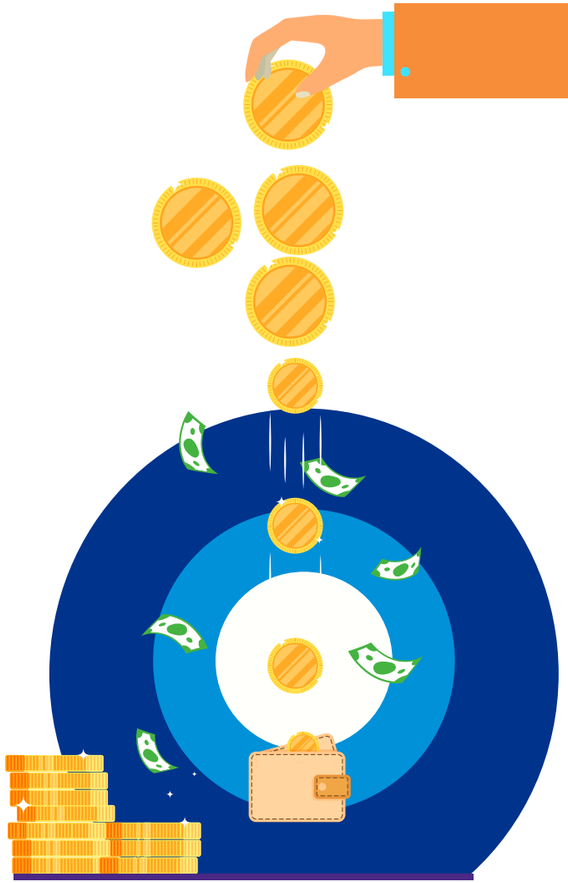
Accordingly, if there are more than one CIC in a group, then an auditor would state the number of CICs in its report. Reporting would also cover CICs exempt from registration and CICs not registered.

### Guidance by ICAI

For the purpose of reporting, an auditor would examine the activities carried on by the company to ascertain whether it satisfies the conditions of a CIC. Additionally, the financial statements of the company would also be verified to determine whether the company meets the specified thresholds (specified above) to be eligible as a CIC.

In case of exempted CICs, an auditor would ascertain whether the company continues to fulfil the exemption criteria of not accessing public funds/issue of guarantees/take on other contingent liabilities on behalf of their group entities.

In order to facilitate reporting on number of CICs in a group, a company would be required to provide the list of companies in the group to an auditor along with details of CICs exempt from registration and CICs not registered. In case the group has no CIC or does not have more than one CIC, the fact would also be reported in the auditor's report.



## Key considerations

The extensive reporting requirement introduced by CARO 2020 relating to NBFCs, HFCs and CICs is intended to safeguard the interests of those who undertake transactions with them. Registration of such companies with RBI is a pre-requisite for their operations. Therefore, reporting in the auditor's report as to their eligibility and whether they continue to fulfil those eligibility conditions would provide useful and relevant information. Such companies should ensure compliance with the directives and guidelines issued by RBI from time to time, in addition to the requirements of the 2013 Act. The compliances would be verified and reported by an auditor in its report to be used by stakeholders at large.

It is important to note that non-compliances with any of the prescribed provisions by NBFCs, HFCs and CICs may also be reported to the RBI by an auditor in the form of an exception report in terms of NBFCs Auditor's Report (Reserve Bank) Directions, 2016.

# Compliances by a Nidhi company

'Nidhi' or a 'mutual benefit society' is a company incorporated with the object of cultivating the habit of thrift and saving amongst its members, receiving deposits from, and lending to, its members only, for their mutual benefit, and which complies with the rules made by the Central Government (CG) for regulation of such class of companies (referred to as Nidhi Rules, 2014). CG may on receipt of an application and subject to fulfillment of prescribed conditions may notify a public company as a Nidhi.

Every Nidhi company should ensure that it complies with the following conditions within a period of one year from the date of its incorporation:

a. It should have a minimum net owned fund of INR10 lakh or more

b. Its unencumbered term deposits should not be less than 10 per cent of the outstanding deposits

c. The Net Owned Funds to Deposits ratio should not be more than 1:20.

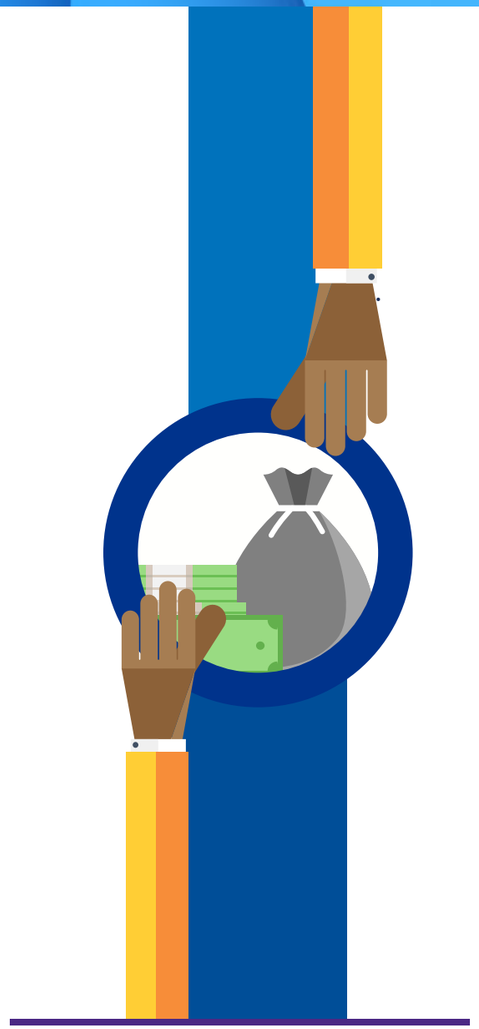
Additionally, it is required to file a half-yearly return in Form NDH-3 with ROC within 30 days from the conclusion of each half-year duly certified by a company secretary in practice, chartered accountant in practice or cost accountant in practice. The return, *inter alia*, include details relating to deposits accepted and loan extended by Nidhi, litigations if any and financial summary covering Net Owned Funds to Deposits ratio and percentage of unencumbered term deposits to total deposits outstanding.

In order to ensure that the Nidhi company is compliant with the prescribed guidelines, the CARO 2020 requires an auditor to comment on the following compliances in its report:

a. Whether the Nidhi company has complied with the Net Owned Funds to Deposits in the ratio of 1:20 to meet out the liability and

b. Whether the Nidhi company is maintaining 10 per cent unencumbered term deposits as specified in the Nidhi Rules, 2014 to meet out the liability.

Unlike CARO 2016, CARO 2020 further requires an auditor to comment on any default in payment of interest on deposits or repayment thereof by a Nidhi company for any period. If yes, the details need to be furnished in the auditor's report.



## Requirements of the 2013 Act

In accordance with the requirements of the 2013 Act, a Nidhi company cannot accept deposits exceeding 20 times of its net owned funds as per its last audited financial statements. Net owned funds mean the aggregate of paid-up equity share capital and free reserves as reduced by accumulated losses and intangible assets appearing in the last audited balance sheet. However, amount representing the proceeds of issue of preference shares will not be included for calculating net owned funds. Deposits could include fixed deposits, recurring deposits and savings deposits from its members.

Further, every Nidhi company is required to invest and continue to keep invested, in unencumbered term deposits an amount which should not be less than 10 per cent of the deposits outstanding at the close of business on the last working day of the second preceding month with a scheduled commercial bank (other than a co-operative bank or a regional rural bank) or post office deposits in its own name.

In cases of unforeseen commitments, temporary withdrawal may be permitted with the prior approval of the Regional Director for the purpose of repayment to depositors, subject to such conditions and time limit which may be specified by the Regional Director to ensure restoration of the prescribed limit of 10 per cent.

## Guidance by ICAI

As per the guidance note, an auditor would report the following details as at the balance sheet date in the auditor's report:

a. *In case of shortfall in the ratio of net owned funds to the deposits:* The amount of shortfall and the actual ratio of net owned funds to the deposits.

b. *In case of shortfall with regard to the minimum amount of 10 per cent as unencumbered term deposits:* The amount thereof.

c. *In case of default in payment of interest on deposit or repayment thereof or both:* An auditor would report the following details in respect of all defaults existing as at the year-end and also those existing during any period and made good during the year:

   i. Nature of default

   ii. Amount of default

   iii. Period of default

   iv. Number of persons to whom there was default in payments

   v. Any other detail.

   In case there is no such default, it would be reported accordingly.

To facilitate reporting, management would be required to provide the computation of the deposit liability and the net owned funds to an auditor for verification of the requisite ratio.

Management of a Nidhi company would also be required to prepare and provide a schedule of payments of interest and repayment of deposits indicating the amount and their due dates. An auditor may also seek documents including Form NDH-3 filed by a Nidhi company containing the terms and conditions of the deposits to ascertain whether the repayments as well as payment of interest as per books of account are in accordance with the terms and conditions of the relevant documents.

In the event of any dispute between a Nidhi company and the depositor on certain issues relating to repayments, the prevailing terms and conditions would be considered by an auditor and a brief about the nature of dispute would be reported in his/her report.

# Key considerations

The MCA has tightened the regulatory norms covering reporting on defaults in payment of deposits accepted by a Nidhi company in an auditor's report. Such a company would now need to maintain a proper schedule of the deposits and their repayments along with details relating to such deposits such as terms and conditions of those deposits. Non-compliances with any of the prescribed norms by a Nidhi company would be reported in the auditor's report.


# Maintenance of cost records

Similar to CARO 2016, CARO 2020 requires an auditor to report on whether maintenance of cost records has been specified by the CG under Section 148(1) of the 2013 Act. If yes, then whether such accounts and records have been so made and maintained by the company.

## Requirement of the 2013 Act

In accordance with Section 148(1) of the 2013 Act, CG may, by order direct specified class of companies[25], that particulars relating to the utilisation of material or labour or to other items of cost as may be prescribed shall also be included in the books of account maintained by them.

Further, CG may also direct specified class of companies to get their cost records audited[26].

### *Definition of cost records*

'Cost records' have been defined as books of account relating to utilisation of materials, labour and other items of cost as applicable to the production of goods or provision of services as provided in Section 148 of the 2013 Act and the Cost Audit Rules. Cost records are required to be maintained as per Form CRA-1.

## Guidance by ICAI

This clause requires an auditor to report whether cost accounts and records have been made and maintained. The word 'made' applies in respect of cost accounts (or cost statements) and the word 'maintained' applies in respect of cost records relating to materials, labour, overheads, etc.

In accordance with the guidance note, an auditor is required to report under this clause irrespective of whether a cost audit has been ordered by the CG. Where maintenance of cost records has not been specified

for the company, this clause will not be applicable, and the auditor may report accordingly.

If maintenance of cost records has been specified for the company by the CG, then it may need to provide a list of books/records made and maintained in this regard. If maintenance of cost records has been specified for only some of the products/activities of the company, then an auditor would limit his/her procedures to only such products/activities.

In case cost audit is applicable to the company, an auditor may obtain copy of cost audit report of immediately preceding year and note any qualifications or comments in the cost audit report. An auditor may enquire from the management, whether such observations have been properly addressed in the current year.

25. Specified class of companies, including foreign companies defined under Section 2(42) of the 2013 Act, engaged in the production of the goods or providing services, with an overall turnover from all its products and services of INR35 crore or more during the immediately preceding financial year. (Rule 3 of the Companies (Cost Records and Audit) Rules, 2014 (Cost Audit Rules)

26. Every company specified Rule 3(A) shall get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is INR50 crore or more and the aggregate turnover of the individual product or products or services for which cost records are required to be maintained under Rule 3 is INR25 crore or more.

    Every company specified Rule 3(B) shall get its cost records audited if the overall annual turnover of the company from all its products and services during the immediately preceding financial year is INR100 crore or more and the aggregate turnover of the individual product or products or service or services for which cost records are required to be maintained under Rule 3 is INR35 crore or more.

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