

# **Guidance on Non-Compliances Observed by Quality Review Board During Quality Reviews (Volume 2)**

**Part - 2  
Observations related to CARO and IFC**



**The Institute of Chartered Accountants of India**  
*(Set up by an Act of Parliament)*  
**New Delhi**

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## **Part 2: Observations related to CARO and IFC**



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# Foreword

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The Quality Review Board (QRB) was constituted in June 2007 under the provisions of the Chartered Accountants Act, 1949. QRB conducts quality reviews of audit services of audit firms which are covered under its domain. These quality reviews bring out instances of various non-compliances of Standards on Quality Control (SQC), Standards on Auditing (SAs), audit reports, Companies (Auditor's Report) Order (CARO), Accounting Standards (AS), Indian Accounting Standards (Ind AS), Schedule VI of Companies Act, 1956/ Schedule III of Companies Act, 2013 etc.

Based on observations noticed during these quality reviews, QRB issues necessary advisories to concerned audit firms. On the matter, QRB requested the Council of ICAI to bring out necessary guidance for the members of ICAI based on common non-compliances observed. I am happy to note that the Auditing and Assurance Standards Board ('Board' or 'AASB') has undertaken the project and earlier, in May 2024 released Volume 1 of "Guidance on Non-Compliances Observed by Quality Review Board During Quality Reviews". Now, it is heartening to learn that the Board is bringing out Volume 2 of "Guidance on Non-Compliances Observed by Quality Review Board During Quality Reviews".

This publication is a compilation of 47 common non-compliances observed by QRB while conducting quality reviews and covering 61 cases received from QRB. The publication also contains guidance suggested by AASB for the members on these common non-compliances. The purpose of this publication is to provide awareness to the members about common non-compliances observed by QRB and help them in performing quality audits.

I compliment CA. (Dr.) Sanjeev Kumar Singhal, Chairman, CA. Vishal Doshi, Vice-Chairman and all other members of the Auditing and Assurance Standards Board for their efforts in developing and bringing out this publication for the benefit of the members at large.

I am confident that the members and other interested readers would find this publication immensely useful.

June 26, 2024  
New Delhi

**CA. Ranjeet Kumar Agarwal**  
President, ICAI



# Preface

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Review of the quality of audit services performed by audit firms is an important mechanism to improve audit quality. In this regard, the role performed by the Quality Review Board (QRB) over the years is significant. The quality reviews conducted by QRB bring out instances of various non-compliances regarding (a) auditing requirements e.g. Standards on Quality Control, Standards on Auditing, audit reports, CARO, and (b) accounting requirements e.g. Accounting Standards, Indian Accounting Standards, Schedule VI of Companies Act, 1956/ Schedule III of Companies Act, 2013. Based on observations noticed during these quality reviews, QRB issues necessary advisories to concerned audit firms. QRB requested the Council of ICAI to bring out necessary guidance for the members of ICAI. The task was entrusted to the Auditing and Assurance Standards Board (AASB) of ICAI.

AASB decided to engage various experts to prepare suggested guidance for the members on the matter. AASB also decided to constitute a consolidating group to review guidance prepared by these experts. It was also decided by AASB to bring out the guidance in separate volumes since this task is quite voluminous. In May 2024, AASB released Volume 1 of the publication “Guidance on Non-Compliances Observed by Quality Review Board During Quality Reviews.

It gives us immense pleasure to place in hands of the members, this Volume 2 of the publication, “Guidance on Non-Compliances Observed by Quality Review Board During Quality Reviews” brought out by AASB. The publication is a compilation of some common non-compliances of auditing requirements observed by QRB while conducting quality reviews. The publication also contains suggested guidance by AASB for the members on these common non-compliances. The publication is in two parts i.e. Part 1 and Part 2. Part 1 contains the observations related to Engagement and Quality Control Standards. Part 2 contains the observations related to CARO and internal financial controls.

We would like to thank CA. Ranjeet Kumar Agarwal, President, ICAI and CA. Charanjot Singh Nanda, Vice-President, ICAI for their guidance and support in various endeavours of the Board.

We express our sincere thanks to Ms. Shefali Shah, IRS (Retd.), Chairperson, Quality Review Board and all the members and special invitees of the Quality Review Board for providing us the various observations noted by the Quality Review Board during quality reviews, which form the basis of this publication.

We are grateful to all experts viz. CA. Amit Kumar Garg, CA. Kulbhushan Sharma, CA. Kusai Goawala, CA. Nilanjan Paul, CA. Rajiv Sengupta, CA. Sanat Chitale and CA. Umesh Chand Goyal for preparing the basic draft of guidance which has been included in this publication. We are also grateful to all members of the consolidating group viz. CA. Amit Chugh, CA. Amit Gupta, CA. Ashish Gupta, CA. Gaurav Gupta, CA. Kapil Kedar, CA. Rajeev Saxena and CA. Viren Shah for their contribution in reviewing and finalizing the guidance.

We wish to place on record high appreciation of all Council members and all Board members for their valuable contribution in finalising the publication. We appreciate the technical and administrative contribution/support provided by CA. Megha Saxena, Secretary, AASB, CA. Rajnish Aggarwal, Assistant Director, CA. Vikas Kumar, CA Professional, CA. Nidhi Mallick, CA Professional, Ms. Anitha P., Private Secretary(SU) and other staff of AASB in finalising the publication.

We are confident that the publication would be well received by the members and other interested readers. We are of the firm belief that the publication would enhance the knowledge of auditors and would help them in performing quality audits.

**CA. Vishal Doshi**  
Vice Chairman, AASB

**CA. (Dr.) Sanjeev Kumar Singhal**  
Chairman, AASB

# Introduction

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## About the Quality Review Board

With a view to improving the quality of audit services in India, the Ministry of Corporate Affairs, Government of India has established the Quality Review Board (“QRB”) under Section 28A of the Chartered Accountants Act, 1949. Section 28B of the Chartered Accountants Act, 1949 authorises the QRB to perform the following functions:

- (a) to make recommendations to the Council with regard to the quality of services provided by the members of the Institute;
- (b) to review the quality of services provided by the members of the Institute including audit services;
- (c) to guide the members of the Institute to improve the quality of services and adherence to the various statutory and other regulatory requirements; and
- (d) to forward cases of non-compliance with various statutory and regulatory requirements by the members of the Institute or firms, noticed by it during the course of its reviews, to the Disciplinary Directorate for its examination.

QRB conducts quality reviews of audit services of audit firms which are covered under its domain. These quality reviews involve assessment of the work of statutory auditors so that QRB is able to assess (a) quality of audit and reporting by the statutory auditors; and (b) quality control framework adopted by the audit firms in conducting audit.

These quality reviews bring out instances of various non-compliances regarding Standards on Quality Control, Standards on Auditing, audit reports, CARO, Accounting Standards, Indian Accounting Standards, Schedule VI of Companies Act, 1956/ Schedule III of Companies Act, 2013. Based on observations noticed during these quality reviews, QRB issues necessary advisories to concerned audit firms. QRB also refers these instances to the Council of the Institute of Chartered Accountants of India (ICAI). On the matter, QRB requested the Council of ICAI to bring out necessary guidance for the members of ICAI. The task of developing the guidance was entrusted to the Auditing and Assurance Standards Board (AASB) of ICAI.

## About the Publication

In May 2024, AASB released Volume 1 of the publication “Guidance on Non-Compliances Observed by Quality Review Board During Quality Reviews. AASB has brought out this Volume 2 of the publication, “Guidance on Non-Compliances Observed by Quality Review Board During Quality Reviews”. The publication is a compilation of some common non-compliances regarding Standards on Quality Control, Standards on Auditing, audit reports, CARO, internal financial controls observed by QRB while conducting quality reviews. This publication also contains suggested guidance developed by the Auditing and Assurance Standards Board on these common non-compliances. This publication is in two parts i.e. Part 1 and Part 2.

- Part 1 contains the observations related to Engagement and Quality Control Standards.
- Part 2 contains the observations related to CARO and internal financial controls.

In Part 1, observations have been classified standard-wise. In Part 2, observations have been classified topic-wise. The number of observations is given in Table below.



**Part 1**

| <b>S. No.</b> | <b>Topic</b>     | <b>No. of Observations</b> |
|---------------|------------------|----------------------------|
| 1             | SQC 1            | 5                          |
| 2             | SA 200           | 1                          |
| 3             | SA 210           | 1                          |
| 4             | SA 240           | 1                          |
| 5             | SA 260 (Revised) | 3                          |
| 6             | SA 299 (Revised) | 2                          |
| 7             | SA 300           | 2                          |
| 8             | SA 315           | 1                          |
| 9             | SA 320           | 1                          |
| 10            | SA 330           | 3                          |
| 11            | SA 500           | 2                          |
| 12            | SA 501           | 1                          |
| 13            | SA 520           | 2                          |
| 14            | SA 540           | 1                          |
| 15            | SA 570 (Revised) | 1                          |
| 16            | SA 580           | 1                          |
| 17            | SA 600           | 1                          |
| 18            | SA 620           | 1                          |
| 19            | SA 700 (Revised) | 6                          |
| 20            | SA 705 (Revised) | 3                          |
| 21            | SA 706 (Revised) | 2                          |
| 22            | SA 720 (Revised) | 1                          |
| <b>Total</b>  |                  | <b>42</b>                  |

**Part 2**

| <b>S. No.</b> | <b>Topic</b>                | <b>No. of Observations</b> |
|---------------|-----------------------------|----------------------------|
| 1             | CARO                        | 4                          |
| 2             | Internal Financial Controls | 1                          |
| <b>Total</b>  |                             | <b>5</b>                   |

Readers may note that some observations given in this publication are based on the past provisions of law (e.g. CARO 2003, CARO 2016) and the pre-revised Standards on Auditing. In case of these observations, guidance has been given based on the current provisions of law (e.g. CARO 2020) and currently applicable Standards on Auditing. Further, these observations should be read in the light of any subsequent amendments/developments.

Readers may also note that this publication neither supersedes nor it is a replacement of any Standards, Guidance Notes, Pronouncements issued by ICAI. Readers are advised to read or use this publication in conjunction with the relevant Standards, Guidance Notes, Pronouncements issued by ICAI.

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# Chapter 1

## Observations related to CARO

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### Observation 1

The use of the word 'as informed' in para (i)(b) and 'according to the information & explanation given to us' in para (iv), (vii), (ix), (xii) & (xvi) should not have been made alone as the auditor is supposed to state in the audit report his opinion based on the examination of such records and accounts or other documents of the company which have not been stated in the report.

### What is the issue?

Whether auditor needs to examine the records of the company to give audit report on CARO or can he rely on management's representations?

### AASB Suggested Guidance

As per "Guidance Note on the Companies (Auditor's Report) Order, 2020 (Revised 2022 Edition)" ("**Guidance Note on CARO 2020**"), there should be evidence that the opinion expressed by the auditor is based on an examination made by him.

There should be evidence to show that in arriving at his opinion, the auditor has given due cognisance to the information and explanations given by the company.

### Technical Literature

#### Relevant Paragraphs of Guidance Note on CARO 2020

##### Para 29

The Order does not replace an audit by an investigation in respect of the matters specified therein. Many of these matters, in any case, are covered by an auditor in the normal course of his audit and the emphasis of the Order is not, therefore, on requiring the auditor to carry out an investigation but on requiring him to give specific information on certain aspects of his work.

##### Para 30

The reporting under the Order is supplemental to the audit of financial statements of the company. The procedures required to be performed by the auditor would generally be within the framework of the principles enunciated in Standards on Auditing (SAs) prescribed under section 143(10) of the Act. However, reporting on various clauses of the Order may require specific audit procedures to be performed which could be in addition to audit procedures required to express an opinion on the financial statements.

**Para 31**

It is possible that for the purposes of the Order, the auditor needs greater information from the management. The auditor and the management should ensure that there is sufficient advance planning regarding the manner in which the examination necessary for reporting on matters specified in the Order would be carried out by the auditor and the form in which the company should maintain its records so that they provide the necessary information and evidence to the auditor. An example of this would be the documents and records to be maintained by the company to provide the requisite evidence to the auditor regarding verification of property, plant and equipment or inventories. It is, therefore, suggested that the auditor should intimate to the management, in writing, his requirements before the commencement of each audit. The auditor should also consider intimating additional requirements, if any, during the course of the audit. The auditor should also consider obtaining management representations on matters on which the Order requires the auditor to make a statement on certain aspects.

**Para 32**

For a number of reasons, the necessity for preserving working papers by the auditors assumes greater importance in the context of the requirements of the Order. Firstly, there should be evidence that the opinion expressed by the auditor is based on an examination made by him. Secondly, there should be evidence to show that in arriving at his opinion, the auditor has given due cognisance to the information and explanations given by the company. Thirdly, there should be evidence to show that the information and explanations obtained were full and complete, that is, the auditor has sought and obtained all the information and explanations which to the best of his knowledge and belief were necessary to be considered before arriving at his opinion. Finally, there should be evidence to show that the auditor did not merely rely upon the information or explanations given by the company but that he subjected such information and explanations to reasonable tests to verify their accuracy and completeness.

**Para 33**

As the auditor needs to comply with the requirements of SA 230, "Audit Documentation", the auditor may take the following steps to ensure that he has adequate working papers to support the conclusions drawn in his report:

- (a) submit to the company, a questionnaire on all important matters covered by the Order.
- (b) make specific inquiries in writing on all important matters not covered by the questionnaire.
- (c) insist that replies of the company are furnished in writing and are signed by a responsible officer of the company.
- (d) where the explanations are not already separately recorded, maintain a record of the discussions with the management.
- (e) prepare his own "checklist" in respect of the requirements of the Order and record the names of the members of his staff who made the examination and the name of the company's staff who provided the information. An illustrative checklist in respect of the requirements of the Order is given in Appendix V to this Guidance Note.

### **Observation 2**

Non-compliance in respect of not performing the audit procedure of arriving at book inventories on the basis of an annual reconciliation of opening inventory, purchases and consumption while examining whether material discrepancies have been noticed on physical verification of inventories when compared with book records while reporting in CARO in terms of clause 3(ii)(a) of CARO 2020.

### **What is the issue?**

What is the reporting requirement under clause 3(ii)(a) of CARO 2020?

### **AASB Suggested Guidance**

As per clause 3(ii)(a) of CARO 2020, auditor is required to report:

Whether physical verification of inventory has been conducted at reasonable intervals by the management and whether, in the opinion of the auditor, the coverage and procedure of such verification by the management is appropriate; whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books of account.

Please refer Guidance Note on CARO 2020 for details.

### **Technical Literature**

#### **Relevant Provisions**

- This clause requires the auditor to comment whether the management has conducted physical verification of inventory at reasonable intervals, and whether the coverage and procedure of such verification by the management is appropriate. This clause also requires the auditor to comment on whether any discrepancies of 10% or more in the aggregate for each class of inventory were noticed and if so, whether they have been properly dealt with in the books of account.
- AS 2, “Valuation of Inventories” and Ind AS 2, “Inventories” define “Inventories” as follows:  
“Inventories are assets:
  - held for sale in the ordinary course of business;
  - in the process of production for such sale; or
  - in the form of materials or supplies to be consumed in the production process or in the rendering of services.”
- Inventories encompass goods purchased and held for resale, for example, merchandise

## **Guidance on Non-Compliances Observed by QRB**

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purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include spare parts, servicing equipment and standby equipment which meet the definition of property, plant and equipment as per AS 10(Revised) or Ind AS 16. Such items are accounted for in accordance with AS 10(Revised) or Ind AS 16.

### **Audit Procedures and Reporting**

- The auditor should obtain reasonable assurance about existence and condition of inventories. Observation of physical verification/ examination of records of physical verification of inventory is the primary source of evidence for the purpose of reporting under this clause. Physical verification of inventory is the responsibility of the management of the company which should verify all material items at least once in a year and more often in appropriate cases. It is, however, necessary that the auditor satisfies himself that the physical verification of inventories has been conducted at reasonable intervals by the management and that there is adequate evidence on the basis of which the auditor can arrive at such a conclusion. For example, the auditor may examine the documents relating to physical verification conducted by the management during the year and also at the end of the financial year covered by the auditor's report.
- There are two principal methods of physical verification of inventories: periodic and continuous. Under the periodic physical verification method, physical verification of inventories is carried out at a single point of time, usually at the year-end or at a selected date just prior to or shortly after the year-end. Under the continuous physical verification method, physical verification of inventory is carried out throughout the year, with different items of inventory being physically verified at different points of time. However, the verification programme is normally so designed that each material item is physically verified at least once in a year and more often in appropriate cases. The continuous physical verification method is effective when a perpetual inventory system of record-keeping is also in existence. Some entities use continuous physical verification methods for certain stocks and carry out a full count of other stocks at a selected date.
- What constitutes "reasonable intervals" depends 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. The management of a company normally determines the periodicity of the physical verification of inventories considering these factors. Normally, wherever practicable, all the material items of inventories should be verified by the management of the company at least once in a year. It may be useful for the company to determine the frequency of verification by 'A-B-C' classification of inventories, 'A' category items being verified more frequently than 'B' category and the 'B' category items being verified more frequently than 'C' category items.
- This clause also requires the auditor to comment on whether in his opinion, the coverage and procedure of such verification by the management is appropriate. What constitutes

“appropriate” is a matter of professional judgement. The coverage and procedure of such verification will normally not be appropriate if it is not reasonable and adequate in relation to the size of the company and nature of its business. While the physical verification of inventories is primarily the duty of the management, the auditor is expected to examine the methods, procedures and the coverage of such verification. The auditor may, if considered appropriate by him, be also present at the time of stock-taking. Where the auditor is present at the time of stock-taking, he should observe the procedure and coverage of physical verification adopted by the stock-taking personnel to ensure that the instructions issued in this behalf are being actually followed. The auditor should also perform test-counts to satisfy himself about the effectiveness of the count procedures.

- The auditor may compare the final inventories with stock records and other corroborative evidence, e.g., inventory statements submitted to banks, etc., for verification purposes. The auditor should determine the reasonableness and adequacy of procedures adopted for physical verification of inventories and its coverage having regard to the nature of inventories, their locations, quantities, value and feasibility of conducting the physical verification. This would require the auditor to exercise his professional judgement.
- The auditor should ascertain whether the management has instituted adequate cut-off procedures. In this regard, the auditor may examine a sample of documents evidencing the movement of inventories into and out of stores, including documents pertaining to periods shortly before and shortly after the cut-off date, and check whether the inventories represented by those documents were included or excluded, as appropriate, during the stock-taking.
- The auditor may determine the appropriateness and the adequacy of the procedures and coverage of physical verification of inventories by examining the related records and documents. These records and documents would also include the policy of the company regarding physical verification. The following are the documents which can be examined by the auditor in this regard:
  - written instructions given by the management to the concerned staff engaged in the physical verification process;
  - physical verification inventory sheets duly authenticated by the field staff and responsible officials of the company;
  - summary sheets/consolidation sheets duly authenticated by the responsible officials;
  - internal memos etc., with respect to the issues arising out of physical verification of inventory;
  - extent of coverage of inventory having regard to their value; and
  - any other relevant documents evidencing physical verification of inventory.

While commenting on this clause, the auditor should point out the specific areas where he believes the procedure of physical verification of inventory is not reasonable or adequate.



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- The auditor should also pay attention to ascertain whether the management has established adequate procedures for physical verification of inventories, so that in the normal circumstances, the programme of physical verification will cover all material items of inventory at least once during the year. The auditor should also determine whether the procedures for identifying damaged and obsolete items of inventory are well designed and operate properly. For items of stock which are held by third parties, the auditor should obtain confirmations for stock held by them. In case, in the opinion of the auditor, the procedures and coverage of physical verification of inventories is not appropriate, the auditor has to report the same.
- This clause further requires the auditor to examine whether any discrepancies of 10% or more in the aggregate for each class of inventory have been noticed on physical verification of inventories when compared with books of account. As per paragraph 27 of AS 2, common classifications of inventories are raw materials and components, work in progress, finished goods, stock-in-trade (in respect of goods acquired for trading), stores and spares, and loose tools. As per paragraph 37 of Ind AS 2, common classifications of inventories are merchandise, production supplies, materials, work in progress and finished goods. Goods-in-transit will form part of the relevant class of inventory to which the goods belong. Only in cases where discrepancy of 10% or more arises in value, for any class of inventory, the auditor has to report the fact and also report whether they have been properly dealt with in the books of account. It may be noted that for the purpose of reporting under this clause, materiality threshold as may be applicable for the auditee is not relevant. What is of relevance is discrepancy of 10% or more in value, for any class of inventory, which may or may not be material, but reporting is required in such cases. The 10% threshold for reporting must be applied on a net basis after adjusting excesses and shortages within the class of an inventory and must be based on value for each class of inventory. Even where such discrepancy results in a net excess of 10% for any class of inventory, reporting would still be required. The calculation of the discrepancy should be made at the time when physical verification of inventory was made and in case of perpetual inventory system it will require aggregation of book stock, physical stock and discrepancies for computing the threshold of 10%. In case where the same has not been appropriately dealt with in the books of account, the extent of the discrepancies and its impact on the financial statements need to be reported. Such an examination is possible when quantitative records are maintained for inventories but in many cases circumstances may warrant that records of individual issues (particularly for stores items) are not separately maintained and the closing inventory is established only on the basis of year-end physical verification. Where such day-to-day records are not maintained, the auditor will not be able to arrive at book value of inventories except on the basis of an annual reconciliation of opening inventory, purchases and consumption. This reconciliation is possible when consumption in units can be co-related to the production, or can be established with reasonable accuracy. Where such reconciliation is not possible, the auditor would be unable to determine the discrepancies. In such cases where the discrepancy cannot be determined, the auditor will have to report that he is unable to determine the discrepancy, if any, on physical verification for the item or class of items.

### **Observation 3**

Audit firm has not observed/disclosed in their CARO Report under clause (i)(b) about the presence/non-presence of any material discrepancies noticed during such physical verifications.

#### **Note:**

This observation is based on CARO 2016. The corresponding clause of CARO 2020 is given below.

Clause 3(i)(b): Whether these Property, Plant and Equipment have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account.

### **What is the issue?**

What is the reporting requirement under clause 3(i)(b) of CARO 2020?

### **AASB Suggested Guidance**

As per clause 3(i)(b) of CARO 2020, auditor is required to report:

Whether these Property, Plant and Equipment have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account.

Please refer Guidance Note on CARO 2020 for details.

### **Technical Literature**

#### **Relevant Provisions**

- This clause requires the auditor to comment whether the property, plant and equipment (PPE) of the company have been physically verified by the management at reasonable intervals. This clause further requires the auditor to comment whether any material discrepancies were noticed on such verification and if so, whether those discrepancies have been properly dealt with in the books of account. In case of companies required to comply with Ind AS, it may be noted that in case of right of use (ROU) assets covered under Ind AS 116, where the auditee, under a lease agreement, obtains the right to use an asset, the same should also be considered by the auditor for reporting under this clause.

In case of companies required to comply with Ind AS, it may also be noted that investment property (as defined under Ind AS 40) and non-current assets held for sale (as defined under Ind AS 105) will also be considered by the auditor for reporting under this clause.

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- Physical verification of the assets is the responsibility of the management and, therefore, has to be carried out by the management itself and not by the auditor. It is, however, necessary that the auditor satisfies himself that such verification was done and that there is adequate evidence on the basis of which he can arrive at such a conclusion. The auditor may prefer to observe the verification, particularly when verification of all assets can be made by the management on a single day or within a relatively short period of time. If, however, verification is a continuous process or if the auditor is not present when verification is made, then he should examine the instructions issued to the staff (which should, therefore, be in writing) by the management and should examine the working papers of the staff to substantiate the fact that verification was done and to determine the name and competence of the person who did the verification. In making this examination, it is necessary to ensure that the person making the verification had the necessary technical knowledge where such knowledge is required. It is not necessary that only the company's staff should make verification. It is also possible that verification is made by outside expert agencies engaged by the management for the purpose.

## **Audit Procedures and Reporting**

- The auditor should examine whether the method of verification was reasonable in the circumstances relating to each asset. For example, in the case of certain process industries, verification by direct physical check may not be possible in the case of assets which are in continuous use or which are concealed within larger units. It would not be realistic to expect the management to suspend manufacturing operations merely to conduct a physical verification of the assets, unless there are compelling reasons which would justify such an extreme procedure. In such cases, indirect evidence of the existence of the assets may suffice. For example, the very fact that an oil refinery is producing at normal levels of efficiency may be sufficient to indicate the existence of the various process units even where each such unit cannot be verified by physical or visual inspection. It may not be necessary to verify assets like building by measurement except where there is evidence of alteration/demolition. At the same time, in view of the possibility of encroachment, adverse possession, etc., it may be necessary that a survey is made periodically of open land.
- It is advisable that the assets are marked with "distinctive numbers" especially where assets are movable in nature and where verification of all assets is not being conducted at the same time.
- This clause requires the auditor to report whether the management has verified the property, plant and equipment at reasonable intervals. What constitutes "reasonable intervals" depends upon the circumstances of each case. The factors to be taken into consideration in this regard include the number of assets, the nature of assets, the relative value of assets, difficulty in verification, situation and geographical spread of the location of the assets, etc. The management may decide about the periodicity of physical verification of property, plant and equipment considering the above factors. While an annual verification may be reasonable, it may be impracticable to carry out the same in some cases. Even in such cases, the verification programme should be such that all assets are verified at least once in every three years. Where verification of all assets is not made during the year, it will be

necessary for the auditor to report that fact, but if he is satisfied regarding the frequency of verification he should also make a suitable comment to that effect.

- The auditor is required to state whether any material discrepancies were noticed on verification and, if so, whether the same have been properly dealt with in the books of account. The latter part of the statement is required to be made only if the discrepancies are material. The auditor has, therefore, to use his professional judgement to determine whether a discrepancy is material or not. In making this judgement, the auditor should consider not only 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. If a material discrepancy has been properly dealt with in the books of account (which may or may not imply a separate disclosure in the accounts depending on the circumstances of the case), it is not necessary for the auditor to give details of the discrepancy or of its treatment in the accounts but he is required to make a statement that a material discrepancy was noticed on the verification of property, plant and equipment and that the same has been properly dealt with in the books of account.
- As mentioned above, for the purpose of reporting under this clause, the auditor has to use his professional judgement to determine whether a discrepancy is material or not. Factors which may be considered for this purpose may be as follows:
  - the cost of the asset / asset class and its relationship to the total cost of all assets by percentage value or numerical count.
  - the nature of the significance of the asset, its value, in the overall production/processing/manufacturing process (for example, mission-critical assets), operational criticality of the asset, its current situation / location.
  - materiality threshold may be different for different industries and may also depend on the size, nature and complexity of the business of the entity.
  - material discrepancy is such that, if it is omitted to be reported or considered, may fail to give a true and fair view of the property, plant and equipment of the company.

**Observation 4**

The firm in their CARO Report under clause (ix) should mention that no term loans were raised and hence the question of applicability of the same does not arise. This reporting was omitted in clause (ix) of the CARO Report of the firm.

**Note:**

This observation is based on CARO 2016. The corresponding clause of CARO 2020 is given below.

Clause 3(ix)(c): Whether term loans were applied for the purpose for which the loans were obtained; if not, the amount of loan so diverted and the purpose for which it is used may be reported.

**What is the issue?**

What is the reporting requirement under clause 3(ix)(c) of CARO 2020?

**AASB Suggested Guidance**

As per clause 3(ix)(c) of CARO 2020, auditor is required to report:

Whether term loans were applied for the purpose for which the loans were obtained; if not, the amount of loan so diverted and the purpose for which it is used may be reported.

Please refer Guidance Note on CARO 2020 for details.

**Technical Literature**

**Relevant Provisions**

- Under this clause, the auditor is required to examine whether term loans were applied for the purpose for which these loans were obtained. Further where the term loans were not applied for the purpose for which these loans were obtained, the auditor is also required to report the amount of loan so diverted and the purpose for which it is used. First of all, the auditor should ascertain whether the company has taken any “term loans”. Term loans normally have a fixed or pre-determined repayment schedule. In the common parlance of the expression, loans with repayment period beyond 36 months are usually known as term loans. Cash credit, overdraft and call money accounts/deposits are therefore not covered by the expression “Term Loans”.
- Reserve Bank of India vide its Master Circular RBI/2015-16/100 DBR.No.CID. BC.22/20.16.003/2015-16 dated July 1, 2015 on “Wilful Defaulters” (as updated from time to time) has defined diversion of fund as:

Diversion of funds would be construed to include any one of the undernoted occurrences:

- 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;

- transferring borrowed funds to the subsidiaries / Group companies or other corporates by whatever modalities;
- routing of funds through any bank other than the lender bank or members of consortium without prior permission of the lender;
- investment in other companies by way of acquiring equities / debt instruments without approval of lenders;
- shortfall in deployment of funds vis-à-vis the amounts disbursed / drawn and the difference not being accounted for.

### **Audit Procedures and Reporting**

- The Order is silent as to whether this clause also covers term loans obtained from entities/persons other than banks/financial institutions. A strict interpretation of this clause would mean that the term loan obtained from entities/persons other than banks/financial institutions would also have to be examined by the auditor for the purpose of reporting under this clause.
- The auditor should examine the terms and conditions subject to which the company has obtained the term loans. The auditor may also examine the proposal for grant of loan made to the lender. Normally the end use of the funds raised by term loans is mentioned in the sanction letter or documents containing the terms and conditions of the loan. The auditor should ascertain the purpose for which term loans were sanctioned. The auditor should also compare the purpose for which term loans were sanctioned with the actual utilisation of the loans. The auditor should obtain sufficient appropriate audit evidence regarding the utilisation of the amounts raised. If the auditor finds that the funds have not been utilised for the purpose for which they were obtained, the auditor's report should state the fact.
- It is not necessary to establish a one-to-one relationship with the amount of term loan and its utilisation. It is quite often found that the amount of term loan obtained is deposited in the common account of the company from which subsequently the utilisation is made. In such cases, it should not be assumed that the amount has not been utilised for the purpose for which it was obtained.
- Schedule III to the Act requires the management to provide disclosures where borrowings from banks and financial institutions were not used for the specific purpose for which it was taken at the balance sheet date and the company is required to disclose details of where they have been used in the financial statements of the company itself. CARO 2020 prescribes reporting on term loans from any party. However, disclosures under Schedule III to the Act are not limited to term loans but cover all borrowings. Further, disclosures under Schedule III to the Act have been prescribed only for borrowings from banks and financial institutions. The auditor should review such disclosures before making a comment under this clause.
- The auditor will need to examine whether the company has utilised the term loans for any of the purposes defined as diversion by the RBI circular as mentioned above. Such process may include checking whether the company has granted loans to other parties, including related parties, or made investments in other companies.

## **Guidance on Non-Compliances Observed by QRB**

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- It may happen that the company might have acquired improved version/model of assets as against the assets for which the loan had been sanctioned. For example, if a loan sanctioned for purchase of machinery to be used for manufacture of shoe upper is instead used to purchase a machine, which apart from manufacturing shoe uppers has certain additional manufacturing facilities. In such cases, it should not be construed that the loan has not been applied for the purpose for which it was obtained.
- Normally, the term lenders directly make the payment to the vendor/suppliers. In such cases, it becomes easier for the auditor to comment on the application of term loans.
- During construction phase, companies, generally, temporarily invest the surplus funds to reduce the cost of capital or for other business reasons. However, subsequently the same are utilised for the stated objectives. In such cases, the auditor should mention the fact that pending utilisation of the term loan for the stated purpose, the funds were temporarily used for the purpose other than for which the loan was sanctioned but were ultimately utilised for the stated end-use.
- It may so happen that the term loans taken during the year might not have been applied for the stated purpose during the year, for example, the loan was disbursed at the fag-end of the year. In such a case, the auditor should mention in his audit report that the term loan obtained during the year has not been utilized because moneys were raised at the fag-end of the year. This also implies that the auditor, while making inquiry in respect of this clause, should also consider the term loans which although were taken in the previous accounting period but have been actually utilised during the current accounting period.
- It may happen that under Ind AS framework, certain term loans (for example, Mezzanine loans) may either be classified as equity or may be compound instruments and, therefore, are split into equity and debt components. However, such instruments will be classified as debt under AS framework. It is clarified that the basic character of such loans is debt and accordingly the auditor should consider utilization of entire amount for the purpose of reporting under this clause irrespective of the accounting treatment.
- It may happen that a company has taken general purpose term loans. In such a case, the auditor should verify whether such loan has been used for any purpose defined as diversion in the RBI circular as mentioned above. Where the company has applied the general purpose loan for any such purpose which can be defined as a diversion, then in such circumstances the auditor shall be required to report accordingly.
- Where the auditor concludes that the term loans were not applied for the purpose for which the loans were obtained, the auditor should ascertain the amount so diverted and the purpose for which such loan was used. The auditor should mention in his report the amount of term loan as well as the fact the term loan was not utilised for the purpose for which it was obtained and report the amounts diverted and purpose for which such loan was used.

## Chapter 2

### Observations related to Internal Financial Controls

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#### Observation 1

It was noted that audit firm had given opinion on reporting on internal financial controls in incorrect location.

#### What is the issue?

What should be the location of opinion on reporting on internal financial controls in the audit report?

#### **AASB Suggested Guidance**

ICAI has issued the “Guidance Note on Audit of Internal Financial Controls Over Financial Reporting”. The Guidance Note provides detailed guidance on reporting requirement of Section 143(3)(i) of the Companies Act 2013 including the illustrative formats of auditor’s report.

The auditor should ensure that various headings covered under the auditor’s report on the Internal Financial Controls under Section 143(3)(i) of the Companies Act, 2013 are placed in sequential manner as per the illustrative format of auditor’s report given in the Guidance Note.

#### **As per para 157 of the Guidance Note:**

The auditor’s report on the audit of internal financial controls over financial reporting must include the following elements:

- a. A title that includes the word independent;
- b. A statement that management is responsible for maintaining adequate and effective internal financial controls over financial reporting and for assessing the adequacy and effectiveness of internal financial controls over financial reporting as per the meaning of internal financial controls provided in the Act;
- c. An identification of the benchmark criteria used by the management for establishing internal financial controls over financial reporting;
- d. A statement that the auditor’s responsibility is to express an opinion on the company’s internal financial controls over financial reporting based on his or her audit;
- e. A statement that the audit was conducted in accordance with the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting and the Standards on Auditing, to the extent applicable to an audit of internal financial controls over financial reporting, both issued by the Institute of Chartered Accountants of India;



## **Guidance on Non-Compliances Observed by QRB**

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- f. A statement that the Guidance Note on Audit of Internal Financial Controls Over Financial Reporting and Standards on Auditing require that the auditor plan and perform the audit to obtain reasonable assurance about whether adequate and effective internal financial controls over financial reporting were maintained in all material respects;
- g. A statement that an audit includes obtaining an understanding of internal financial controls over financial reporting, assessing the risk that a material weakness exists, testing and evaluating the adequacy and operating effectiveness of internal control over financial reporting based on the assessed risk, and performing such other procedures as the auditor considered necessary in the circumstances;
- h. A statement that the auditor believes the audit provides a reasonable basis for his or her opinion;
- i. A paragraph stating that, because of inherent limitations, internal financial controls over financial reporting may not prevent or detect misstatements and that projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate;
- j. The auditor's opinion on whether the company maintained, in all material respects, adequate internal financial controls over financial reporting and whether they were operating effectively as of the balance sheet date, based on the control criteria;
- k. The signature of the auditor with firm name, where applicable;
- l. The place and date of the audit report.

## **Technical Literature**

As per para 158, 159 and 160 of the Guidance Note:

### **Para 158:**

The auditor may issue separate reports on the company's financial statements and on internal financial controls over financial reporting.

### **Para 159:**

Examples of separate unmodified report on internal financial controls over financial reporting in the case of the standalone and consolidated financial statements are given in Appendix III – Example 1 and 5, respectively.

### **Para 160:**

Examples of separate modified report on internal financial controls over financial reporting in the case of the standalone financial statements are given in Appendix III – Examples 2 to 4.

Please refer the illustrative formats of auditor's report given in the Guidance Note.