

## **Statutory Audit Reports – Contents over Disclaimers; Looking beyond Standards**

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### **Introduction**

1. Statutory Audit Reports all across the world have to contain a clear assertion that the financial statements for which the report is being issued, depict a 'True and Fair' (T&F) position of the profitability and financial position as against 'True and Correct'. It is a different matter that the 'True' meaning of the phrase T&F and the role of auditors is still being debated, especially by the users of Financial Statements (FS) for whom the audit reports are meant.
  
2. Reporting for Statutory Auditors in India for companies is governed by statute – the Companies Act, 1956 as well as the Companies Act 2013 mandates the clauses for reporting by statutory auditors. The different assertions to be covered in the statutory audit report are listed in Annexure 1. The Statute, however, only lays down the various points to be included in an audit report – the actual format in which reporting is to be done is governed by the applicable Standards on Auditing (SAs) issued by ICAI [now to be issued by the National Financial Reporting Authority (NFRA)].
  
3. The relevant SAs which deal with audit reporting format are:
  - a. **SA 700 (R)**: Forming an opinion and reporting on financial statements
  - b. **SA 705**: Modifications to the opinion in the Independent Auditors' Report

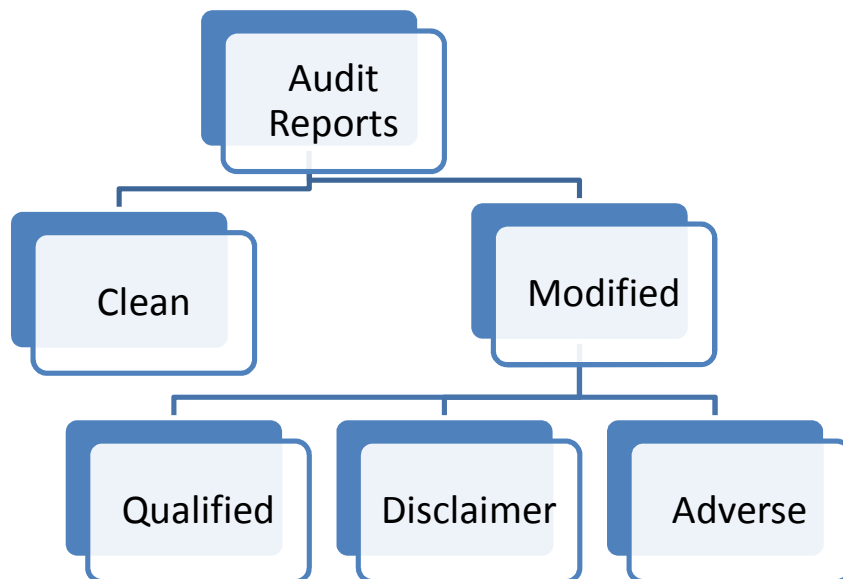
c. **SA 706:** Emphasis of Matter paragraphs and Other Matter paragraphs in the Independent Auditor's report

The ICAI has over the years also issued various statements and guidance notes related to different aspects of audit, audit reporting, revision of audit reports, etc. Since the last few years, these and other SAs issued by ICAI are more or less in line with the International Standards on Auditing (ISAs) issued by IFAC.

4. The combined requirements of SAs and the Companies Act make the size of statutory audit reports in India very lengthy – it is sometimes said that India may well bag the Guinness prize for the length of audit reports !!. It is also an irony that the mere size of these reports makes most readers of financial statements very uncomfortable in reading the reports – the very readers for whom the report is meant are not encouraged to read them!

### **Types of Statutory Audit Reports**

5. As per the above SAs, the types of reports can be bifurcated as under:



6. A majority of the audit reports issued in India are clean reports. Out of the reports which are modified, more than 99 % contain a qualification – which means that subject to that reservation, the financial statements represent T&F position. As the requirement of the SAs, the impact of the qualification is also to be clearly stated in the report itself to enable the users of financial statements to easily understand the impact of such qualification on the reported financials.
7. Audit reports which contain 'disclaimer' i.e. which state that due to adequate information not made available or verifiable, the auditor is unable to give his report or which are 'adverse' i.e. which state that due to various scope or other limitations or misrepresentation, the reported results do not give T&F view, can have a far-reaching impact on the reporting entity. This is because the FS cannot, in such cases, be relied upon and users cannot assess the correctness of either the profitability or the financial position of the entity.
8. Some recent examples of an audit report where a 'disclaimer' report was issued are:
  - a. **Gujarat NRE Coking Coke Ltd.**, the Australian Subsidiary of Gujarat NRE Coke Ltd, India. In this case, the auditor submitted a disclaimer of opinion on the FS of 2012-13 citing that they were unable to obtain sufficient and appropriate audit evidence on the books of accounts and the basis of accounting of the entity. (*Refer BCAJ November 2013 pages 95-99*).  
The impact of such a 'disclaimer' report of a material subsidiary on the audit report of consolidated financial statements of the holding company clearly needs to be considered by the auditor;

- b. **South African Broadcasting Corporation (SABC)** for the year 2012-13, where the Auditor General of South Africa issued a disclaimer of opinion for financials of as he was unable to obtain sufficient and appropriate audit evidence citing financial mismanagement and inadequate controls. *(Reference: Annual Report 2012-13 as available on SABC website- [www.sabc.co.za](http://www.sabc.co.za))*

9. Audit reports can also contain 'Emphasis of Matter' (EoM) paragraph and 'Other Matter' (OM) paragraph in the audit report. As per SA 706:

- a. EoM is included in the auditor's report to refer to a matter that is appropriately presented or disclosed in the financial statements but, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements; An item often included in the EoM paragraph is the Going Concern assumption – a recent example of the same are the reports of 3 listed airline carriers where the auditors have highlighted that the FS are prepared on 'going concern' basis and that their continuing operations are dependent on continued funding support, etc. *(Reference: News report dated 11 November 2013 on [www.moneycontrol.com](http://www.moneycontrol.com): 'Airlines fly into audit red-flags over 'going concern' claims)*
- b. OM is included in the auditor's report to refer to a matter other than those presented or disclosed in the financial statements that, in the auditor's judgment, is relevant to users' understanding of the audit, the auditor's responsibilities or the auditor's report.

10. The placement of EoM and OM paragraphs is after the opinion paragraph – this is to make it clear to the readers that the said

paragraphs do not affect the T&F view of the financial statements, but is only intended to give additional information to the users.

### **Modified reports vs. EoM / OM paragraphs**

11. As can be seen from the above discussion, there is a clear distinction between 'modified' reports and reports that contain an EoM / OM paragraph. However, in many cases, it is seen that company managements 'request' their auditors to replace a 'modified' report with EoM / OM paragraphs in their reports. In such a scenario, it is for the auditor to explain to the management that an EoM / OM paragraph is not a substitute for a 'modified' report.
12. If an auditor instead of giving a 'modified' opinion includes the same subject matter as an EoM / OM paragraph, it cannot absolve him of his responsibility. In the context of the severe penal provisions contained in the Companies Act, 2013, this can become a very risky approach for an auditor.

### **Looking beyond Standards**

13. There have been instances noticed in the past in India that in spite of clean audit reports issued, the said entity has suddenly been engulfed with a so-called 'management perpetrated' scam involving misstatement of financial statements. The 'Satyam scam' is a glaring example of the same. Such instances can even cast serious doubts on the credibility of the audit reports issued.
14. In all such instances, questions which are often raised are – Did the auditor not do his work diligently? Was the auditor helping the

management in manipulation of FS? Was the auditor being rewarded handsomely by the management for turning a blind eye on their wrongdoings?

15. There are several instances where clean reports have been issued in cases where a company has given material inter-corporate loans to group companies or where a majority of the business transactions are with related parties. It is sometimes imperative for the auditor to look beyond the standards and ask a question to himself – 'is the business of the entity sustainable and whether the FS really disclose the said fact?'
16. A management perpetrated fraud can go undetected by the auditor as the management may involve sophisticated and carefully organized schemes designed to conceal it. In such cases, if the auditor has exercised all possible caution and complied with all the requirements of SA 315 (Identifying and Assessing the Risks of Material Misstatements Through Understanding the Entity and its Environment), SA 330 (The Auditor's Responses to Assessed Risks) and SA 240 (The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements) and also has the requisite documentation to prove to that effect, the auditor cannot be held responsible for not reporting the same. Also, in such cases, the benefit of doubt should be given to the auditor as hindsight can make things more obvious which may not be apparent in foresight when the report was issued.
17. In many such instances, the concerned auditors have also 'withdrawn' their audit reports [in terms of SA 560 (Revised) Subsequent Events]. SA 560(R) provides enough guidance to auditors to deal with events that occur after the balance sheet date and the auditor's responsibilities for

facts which become known to the auditor post issuance of his report. SA 560(R) also prescribes the course of action to be taken by an auditor in case of additional information being received during the following two time periods:

- a. From the date of the audit report but before the FS are issued (i.e the date when FS are made available to third parties);
- b. After the FS are issued.

18. Some recent instances of companies where audit reports have been withdrawn or revised audit reports have been issued are:

- a. **Financial Technologies (India) Ltd** – where the audit report for the year ended 31<sup>st</sup> March 2013 was withdrawn due to purported payment crisis and withdrawal of the audit report at one of its subsidiaries; (*Reference: Corporate announcements as available on BSE website*);
- b. **Essar Oil Ltd** – where the audit reports for 3 years were re-issued pursuant to the company amending its FS (post-adoption by the members) for reversal of eligibility of subsidy pursuant to the order of the Hon'ble Supreme Court after obtaining approval of Ministry of Corporate Affairs (*Refer BCAJ February 2013 pages 80-87.*)
- c. **Nagarjuna Fertilizers and Chemicals Ltd** – where the audit report for the year ended 31<sup>st</sup> March 2013 was re-issued pursuant to the company amending its FS (pre-adoption by the members) for reversal of dividend declaration (*Refer BCAJ December 2013*)

19. In the above instances as well as similar other instances which can be faced by an auditor, a question which needs to be answered is whether the mere withdrawal or the revision of the audit report may absolve the

auditor from his responsibility and whether the users of FS will rely on the subsequent FS or subsequent reports issued by the auditor.

## **Conclusion**

20. Clearly, there is a b-i-g expectation gap between what is expected of the auditor and what is actually delivered. Also, the said gap may be deepening further with the recent developments in the Indian corporate scenario. The ICAI should take cognizance of this widening gap and educate the public on what is the real role of auditors and more importantly educate the auditors themselves on the need to issue reports without fear or favour. The provisions of the Companies Act 2013 on rotation of auditors and other provisions are also intended to raise the level of audit reporting and ensuring better independence for the auditors. With all these changes, only the next few years will tell whether the quality of audit reports have risen to a level where the users of FS rely on the said reports.



**Annexure 1: Statutory Assertions to be included in audit report:**

<b>As per Companies Act, 1956</b>		<b>As per Companies Act, 2013</b>	
<b>Section No.</b>	<b>Requirement</b>	<b>Section No.</b>	<b>Requirement</b>
<b>227(2)</b>	To report whether the accounts give information as required by the Act and whether the FS give a True & Fair view of the state of company's affairs and the profit and loss for the financial year.	<b>143(2)</b>	Auditor shall report whether accounts, financial statements give a true and fair view of the state of the company's affairs as at the end of its financial year and profit or loss and cash flow for the year after taking into account: <ul style="list-style-type: none"> <li>- Provisions of this act</li> <li>- Accounting and auditing standards</li> <li>- Matters required to be included in the audit report under provisions of this act</li> </ul>
<b>227(3)(a)</b>	Whether auditor has obtained all the information and explanations necessary for the purpose of his audit.	<b>143(3)(a)</b>	Whether auditor has sought and obtained all the information and explanations which were necessary for the purpose of his audit and if not, the details thereof and the effect of such information on the financial statements.
<b>227(3)(b)</b>	Whether proper books of accounts as required by law have been kept by the company and proper returns have been received from branches not visited.	<b>143(3)(b)</b>	Whether proper books of account as required by law have been kept by the company and proper returns have been received from branches not visited.
<b>227(3)(bb)</b>	Whether the report on the accounts of any branch office audited under Sec 228 by a person other than the company's auditor has been forwarded to him as required by Sec 228(3)(c) and how he has dealt with the same in preparing the auditor's report.	<b>143(3)(c)</b>	Whether the report on the accounts of any branch office of the company audited under Sec 143(8) by a person other than the company's auditor has been sent to him and the manner in which he has dealt with it in preparing his report.
<b>227(3)(c)</b>	Whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with the books of account and returns.	<b>143(3)(d)</b>	Whether the company's balance sheet and profit and loss account dealt with in the report are in agreement with the books of account and returns.

As per Companies Act, 1956		As per Companies Act, 2013	
Section No.	Requirement	Section No.	Requirement
<b>227(3)(d)</b>	Whether the profit and loss account and balance sheet comply with the accounting standards referred to in Sec 211 (3C).	<b>143(3)(e)</b>	Whether, in his opinion, the financial statements comply with the accounting standards
<b>227(3)(e)</b>	In thick type or in italics, the observations or comments of the auditors, which have any adverse effect on the functioning of the company	<b>143(3)(f)</b>	The observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company
<b>227(3)(f)</b>	Whether any director is disqualified from being appointed as a director under Sec 274(1)(g).	<b>143(3)(g)</b>	Whether any director is disqualified from being appointed as a director under Sec 164(2).
<b>227(3)(g)</b>	Whether the cess payable under Sec 441A has been paid and if not, the details of amount of cess not so paid.	<b>143(3)(h)</b>	Any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith
-	-	<b>143(3)(i)</b>	Whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls.

**Notes:**

In respect of a certain class of companies, the auditor is also required to report on certain matters as prescribed under The Companies Audit Report Order (CARO) issued under section 227(4A) of The Companies Act, 1956 – the same matters have not been listed above.

Such certain other matters are also likely be prescribed under section 143(3)(j) of the Companies Act, 2013.