

Analysis and Synopsis of Guidance Note on Reporting under Section 143 (3) (f) and (h) of the Companies Act, 2013

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Introduction

1. Section 143 of the Companies Act, 2013 (hereinafter referred to as the "Act") deals with the powers and duties of the auditors of companies. Section 143(1) of the Act requires the auditor to make certain enquiries during audit and Section 143(2) of the Act requires the auditor to give his report to the members of company on the accounts examined by him. Section 143(3) of the Act also lays down certain matters required to be reported upon by the auditor in his report.

Section 143(3) of Act provides as follows:

"(3) The auditor's report shall also state:

(a) Whether he has sought and obtained all the information and explanations which to the best of his knowledge and belief 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) whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books and proper returns adequate for the purposes of his audit have been received from branches not visited by him;

(c) whether the report on the accounts of any branch office of the company audited under sub-section (8) by a person other than the company's auditor has been sent to him under the proviso to that sub-section and the manner in which he has dealt with it in preparing his report;

(d) 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;

(e) whether, in his opinion, the financial statements comply with the accounting standards;

(f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;

(g) whether any director is disqualified from being appointed as a director under sub-section (2) of section 164;

(h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;

(i) whether the company has adequate internal financial controls system in place and the operating effectiveness of such controls;

(j) such other matters as may be prescribed.

Scope of the Guidance Note

2. This Guidance Note will helps in respect of clauses (f) and (h) of sub-section (3) of section 143 of the Act. Clause (f) and (h) are highlighted as above.

Reporting under Section 143(3)(f) of the Act:

3. The relevant extracts of section 143(3)(f) of the Act are reproduced below:

“(3). *The auditor’s report shall also state:*

.....

(f) the observations or comments of the auditors on financial transactions or matters which have any adverse effect on the functioning of the company;”

4. An auditor’s report may contain matters relating to having adverse effect on the functioning of the company. Therefore, only such “observations” or “comments” which have an adverse effect on the functioning of the company are required to be reported under this clause.

5. The Act does not specify the meaning of the phrase ‘*adverse effect on the functioning of the company*’. A more logical and harmonious interpretation is that this reporting requirement does not intend to change the basic objective and the concept of audit of financial statements of a company, which is to examine the financial statements with a view to express an opinion thereon.

6. The scope of the audit and auditor’s role remains as contemplated under the Standards on Auditing (SAs) 200 and other relevant pronouncements issued by ICAI as well as laid down in the Act. SAs require auditor to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. Reasonable assurance is not an absolute level of assurance because there are inherent limitations of an audit which result in most of the audit evidence on which the auditor draws conclusions and bases the auditor’s opinion being persuasive rather than conclusive.

7. The auditor expresses his opinion on the true and fair view presented by the financial statements through his report which may be modified in certain circumstances. However, the auditor would now have to evaluate the subject matters leading to have an adverse effect on the functioning of the company within the overall context of audit of financial statements of the company. Only such matters which, in the opinion of the auditor, have an adverse effect on the functioning of the company should be reported under this clause.

8. If the auditor has any comments or observations on any of the matters stated in section 143(1), the auditor should consider such comments or observations when reporting under this clause if they contain matters that may have any adverse effect on the functioning of the company.

9. Examples of emphasis of matter which may have an adverse effect on the functioning of the company include situations where:

- the going concern assumption is appropriate but there are several factors leading to a material uncertainty that may cast a significant doubt about the Company’s ability to continue as a going concern; or
- a material uncertainty regarding the outcome of a litigation wherein an unfavourable decision could result in a significant outflow of resources for the company, etc.

Examples of emphasis of matter which may not have an adverse effect on the functioning of the company include a situation where there is an emphasis of matter:

- on managerial remuneration which is subject to the approval of the Central Government;
- relating to accrual of a contractually receivable claim based on management estimate where the ultimate realisation could be different from the amount accrued;
- on frauds that have been dealt with in the financial statements of the company and would not have any continuing effect on the financial statements.

10. If any observations or comments made by the auditor on the adequacy or operating effectiveness of internal financial controls over financial reporting contain such matters, which, in his opinion, may have any adverse effect on the functioning of the company, should also be reported under clause (f) of section 143(3) even if such observation did not result in a modification to the audit opinion on the financial statements of the company. An

example in this regard may be where an auditor reports that the company did not have an appropriate internal control system for inventory with regard to receipts, issue for production and physical verification.

Reporting under Section 143(3)(h) of the Act

12. The relevant extracts of section 143(3)(h) of the Act are reproduced below:

“(3). *The auditor’s report shall also state:*

.....
(h) any qualification, reservation or adverse remark relating to the maintenance of accounts and other matters connected therewith;”

13. The matters that cause such modification may have a consequential effects or possible effects on the books of account maintained by the company and other matters connected therewith.

14. Section 128 of the Act, *inter alia*, states that every company shall prepare and keep its books of account and other relevant books and papers and financial statements that give a true and fair view of the state of affairs of the company.

Section 129(1) of the Act, *inter alia*, states that the financial statements shall comply with the accounting standards notified under section 133 of the Act. Section 2(13) of the Act defines “books of account”.

Clause (b) of section 143(3) requires the auditor to, *inter alia*, state whether, in his opinion, proper books of account as required by law have been kept by the company so far as appears from his examination of those books.

15. Matters to be reported under clause (h) of section 143(3) needs to be evaluated based on the financial statements prepared under the Act. Accordingly, reporting under this clause is determined based on the financial statements prepared i.e., as at the balance sheet date.

16. The words “qualification”, “adverse remark” and “reservation” used in clause (h) of section 143(3) should be considered to be similar to the terms “qualified opinion”, “adverse opinion” and “disclaimer of opinion”, respectively, referred to in SA 705 “Modifications to the Opinion in the Independent Auditor’s Report”.

17. Further, reporting under clause (h) of section 143(3) will be required if the auditor makes any observation under clause (b) of section 143(3) relating to whether proper books of account as required by law have been kept by the company. For example, the auditor may have made an observation on maintenance of cost records under clause (b) of section 143(3) and this may not have had an effect on the financial statements of the company or the auditor’s opinion on the financial statements.

18. If the material weakness in internal financial controls resulted in a modification to the audit opinion on the financial statements, then such modification may be covered for reporting under clause (h) of section 143(3) as stated above.

ILLUSTRATIVE MATTERS FORMING BASIS FOR MODIFIED OPINION OR EMPHASIS OF MATTER PARAGRAPH IN THE AUDITOR'S REPORT AND REQUIRING REPORTING UNDER SECTION 143(3)(f) and/or SECTION 143(3)(h) OF THE COMPANIES ACT, 2013

ILLUSTRATION 1 (Variation from AS-2 Valuation of Inventories)

Basis for Qualified Opinion

The Company’s inventories are carried in the Balance Sheet at Rs. XXX (As at 31st March 20YY: Rs. YYY). The Management has not stated the inventories at the lower of cost and net realisable value but has stated them solely at cost, which constitutes a departure from the Accounting Standard - 2 “Valuation of Inventories”. The

Company's records indicate that had the Management stated the inventories at the lower of cost and net realisable value, an amount of Rs. XXX (As at 31st March 20YY: Rs. YYY) would have been required to write the inventories down to their net realisable value. Accordingly, cost of sales would have been increased by Rs. XXX (Previous year ended 31st March, 20YY: Rs. YYY), and income tax, profit for the year and shareholders' funds would have been reduced by Rs. X, Rs. XX and Rs. XXX, respectively (Previous year ended 31st March, 20YY: Rs. Y, Rs. YY and Rs. YYY, respectively). This matter was also qualified in our report/ the report of the predecessor auditors on the financial statements for the year ended 31st March 20YY.

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the effects of the matter described in the Basis for Qualified Opinion paragraph above, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at 31st March, 20XX, and its profit/loss and its cash flows for the year ended on that date.

.....
.....

Report on Other Legal and Regulatory Requirements

As required by Section 143 (3) of the Act, we report that:

.....
.....

(f) The matter described in the Basis for Qualified Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

.....

(h) The qualification relating to the maintenance of accounts and other matters connected therewith are as stated in the Basis for Qualified Opinion paragraph above."

ILLUSTRATION 2 (Litigation and Question on Going Concern Assumption)

Opinion

In our opinion and to the best of our information and according to the explanations given to us, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India, of the state of affairs of the Company as at 31st March, 20XX, and its profit/loss and its cash flows for the year ended on that date.

Emphasis of Matters

We draw attention to the following matters in the Notes to the financial statements:

a) Note X to the financial statements which, describes the uncertainty related to the outcome of the lawsuit filed against the Company by XYZ Company.

b) Note Y in the financial statements which indicates that the Company has accumulated losses and its net worth has been fully / substantially eroded, the Company has incurred a net loss/net cash loss during the current and previous year(s) and, the Company's current liabilities exceeded its current assets as at the balance sheet date. These conditions, along with other matters set forth in Note Y, indicate the existence of a material uncertainty that may cast significant doubt about the Company's ability to continue as a going concern. However, the financial statements of the Company have been prepared on a going concern basis for the reasons stated in the said Note.

Our opinion is not modified in respect of these matters.

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Report on Other Legal and Regulatory Requirements

As required by Section 143 (3) of the Act, we report that:

.....

(f) The going concern matter described in sub-paragraph (b) under the Emphasis of Matters paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

ILLUSTRATION 3 (Denial to access information during audit)

Basis for Qualified Opinion

ABC Company Limited's investment in XYZ Company, a foreign associate whose net worth has been fully/substantially eroded, is carried at Rs. XXX in the Balance Sheet as at March 31, 20XX. We were unable to obtain sufficient appropriate audit evidence about the carrying amount of ABC Company Limited's investment in XYZ Company as at March 31, 20XX because we were denied access to the financial information, management, and the auditors of XYZ Company. Consequently, we were unable to determine whether any adjustments to these amounts were necessary.

Qualified Opinion

In our opinion and to the best of our information and according to the explanations given to us, except for the possible effects⁵ of the matter described in the Basis for Qualified Opinion paragraph, the aforesaid standalone financial statements give the information required by the Act in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India of the state of affairs of the Company as at 31st March 20XX, and its profit/loss and its cash flows for the year ended on that date.

Report on Other Legal and Regulatory Requirements

As required by section 143 (3) of the Act, we report that:

.....
.....

(f) The matter described in the Basis for Qualified Opinion paragraph above, in our opinion, may have an adverse effect on the functioning of the Company.

.....

(h) The qualification relating to the maintenance of accounts and other matters connected therewith are as stated in the Basis for Qualified Opinion paragraph above.

Disclaimer:

This document contains the information compiled from the Guidance note issued by ICAI for Reporting u/s 143(3) (f) and (h) only to help the professional for drafting Audit Report and it is for personal and private circulation and not bearing any opinion or advice.

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