NANGIA & CO LLP
CHARTERED ACCOUNTANTS

Assurance Gazette

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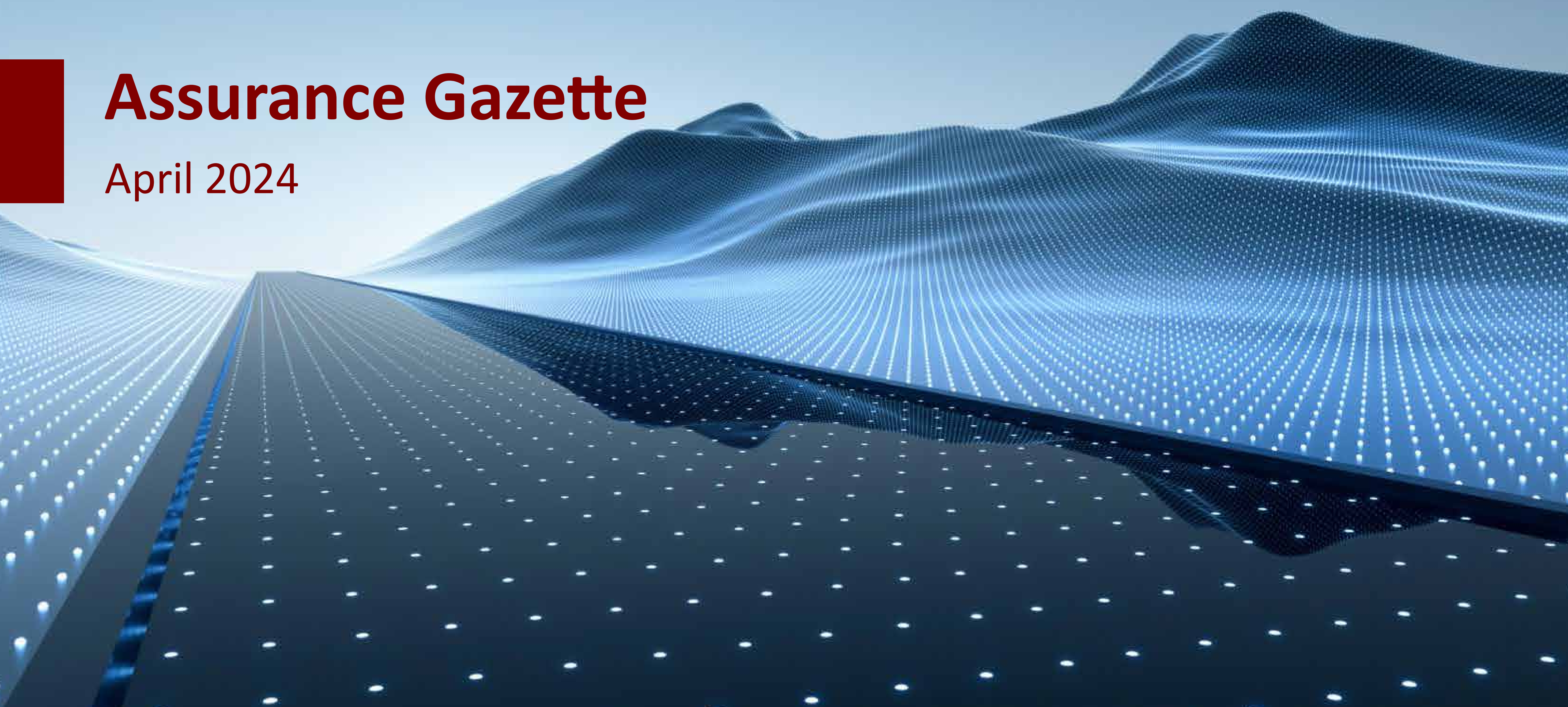


Content

Foreword

The Assurance Gazette of April 2024 presents a crucial discussion on NFRA's unwavering stance against company fraud, emphasizing the paramount importance of accountability and trust in the financial landscape. In this edition, we delve into NFRA's latest circular, which underscores the proactive measures taken to safeguard stakeholders' interests and maintain the integrity of financial reporting. Additionally, it captures the significance of Ind AS 37 for financial reporting and transparency. This standard ensures the accurate portrayal of entities' financial positions by recognizing provisions, contingent liabilities, and assets, thereby aiding stakeholders in making informed decisions.

NFRA's Viewpoint On Company Fraud: Addressing Accountability And Trust

Introduction

In its recent circular NF-25013/2/2023 dated June 26, 2023, NFRA addressed irregularities wherein statutory auditors failed to meet their statutory obligations regarding the reporting of fraud as required by the Companies Act, 2013. In instances of fraud, the auditor must adhere to the guidelines outlined in Section 143(12) of the Companies Act 2013, Clause (xi) of the Companies (Auditor's Report) Order 2020, and SA 240 as delineated by the ICAI.

It is pertinent to note that the definition of fraud under section 447 of Companies Act 2013 is wide and states that, "fraud" in relation to affairs of a company or anybody corporate, 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 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.

The statutory auditor is required to submit Form ADT-4 to the Central Government even if they are not the first person to identify the fraud. The circular also states that resignation by the auditor would not absolve the auditor of their responsibility to report suspected fraud.

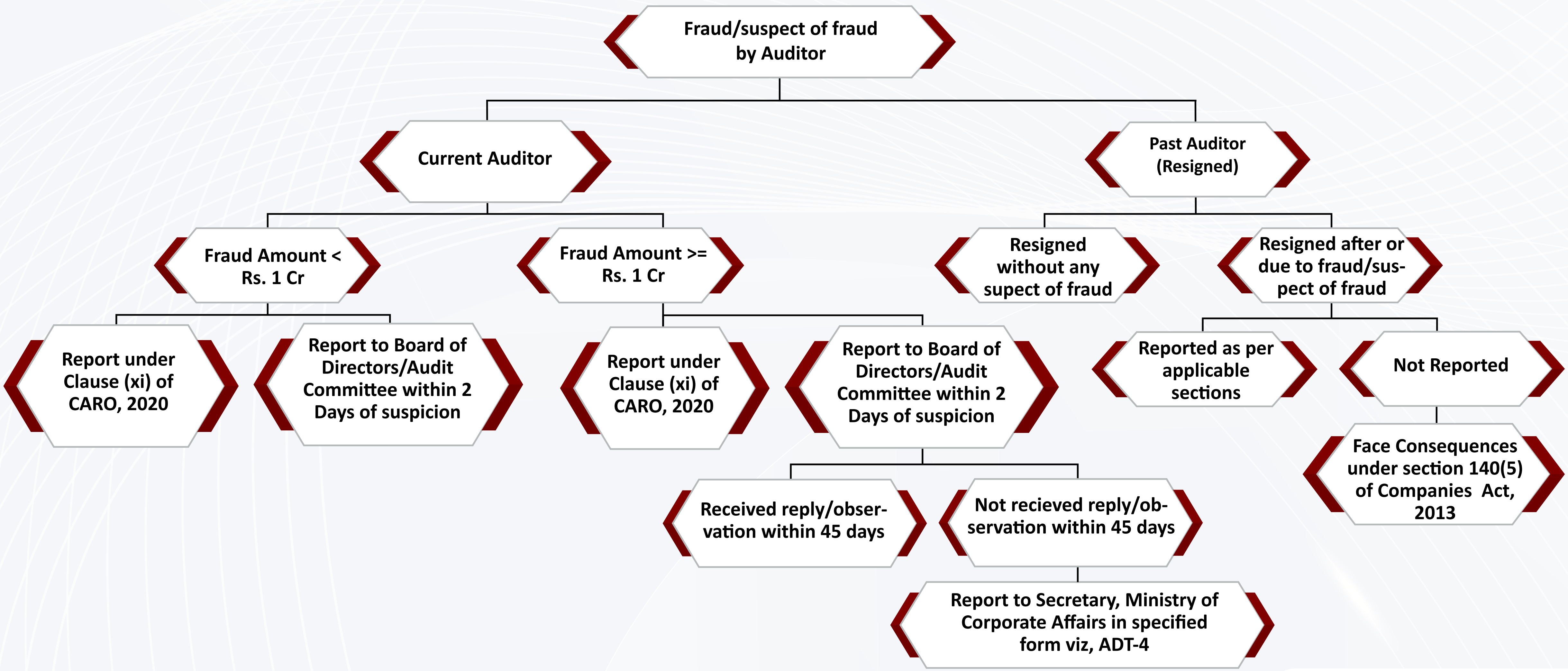
Management Responsibilty In Relation To Fraud

The primary responsibility for prevention and detection of fraud vests with the management and those charged with the governance. Such responsibility includes:

- Designing and implementing effective internal control systems to prevent, detect, and mitigate the risk of fraud.
- Regular assessments to identify areas vulnerable to fraud and take proactive measures to address any identified risks.
- Establish robust monitoring mechanisms to detect and respond promptly to any indications of fraudulent activities.
- Report instances of fraud to relevant authorities, regulatory bodies, and stakeholders in accordance with legal and regulatory obligations.
- Collaborate with auditors to assess the risk of fraud and ensure that appropriate controls are in place to mitigate such risks.
- Provide auditors with unrestricted access to relevant information and personnel to facilitate their audit procedures, including investigations into potential fraud.
- Cooperate fully with auditors during fraud investigations, providing necessary assistance and resources to facilitate the process and ensure its effectiveness.
- Consider and implement any recommendations or suggestions made by auditors to strengthen fraud prevention and detection mechanisms within the organization.

Reporting Obligations In Consequences Of Fraud/suspect Of Fraud By NFRA

If an auditor possesses grounds to suspect that an act of fraud has been perpetrated against the company by its officers or employees, and if such fraudulent activity is deemed detrimental to the interests of the company, its shareholders, creditors, or any other parties involved, the auditor is obligated to report it.



Consequences Under Section 140(5) Of Companies Act, 2013

- The NCLT can remove the auditor in case of a prima facie satisfaction of fraud in the nature of an interim order.
- The auditor shall also be liable for action under section 447.
- If the NCLT finds a commission of fraud, the auditor can be debarred from undertaking an audit for a period of five years.
- Not only will the auditor be dismissed or replaced from their role as an auditor of a company, but they, as an individual auditor or a firm, will also be disqualified from being appointed as an auditor of any other company for a duration of five years.

Unveiling Fraud: The Power Of Professional Skepticism

In accordance with SA 200, the auditor shall maintain professional skepticism throughout the audit, recognizing the possibility that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience of the honesty and integrity of the entity's management and those charged with governance. The Statutory Auditor shall exercise his/her own professional skepticism while evaluating fraud, and need not be influenced by legal opinion provided by the Company or its Management.

Expectations with auditors regarding professional skepticism include:

- Challenge assumptions underlying financial data and scrutinize the rationale behind accounting treatments.
- Demonstrate independence in their assessments, free from undue influence or bias, to arrive at objective conclusions.
- Comprehensive review of audit evidence, leaving no stone unturned in the search for potential misstatements.
- Analysing financial information, identifying inconsistencies, and probing deeper into areas of uncertainty.
- Alertness to indicators of fraud or irregularities, recognizing subtle cues that may signify potential issues.
- Communicate findings transparently and effectively to stakeholders, conveying any concerns or uncertainties regarding financial reporting.
- Staying abreast of evolving accounting standards, industry trends, and emerging risks to enhance their ability to exercise professional skepticism effectively.

Nangia's Take

As a result of recent instances of financial reporting malpractices going unnoticed by auditors, stakeholders have developed some mistrust towards the audit field and financial reporting by companies. Consequently, NFRA and Company Law are releasing new circulars and notifications aimed at addressing prevalent issues and strengthening provisions to curb such malpractices, thereby fostering a more robust ecosystem for financial reporting and auditing. Moreover, resigning due to indication of fraud is not an option for auditors anymore. They are obligated to report their findings to the appropriate authorities and stakeholders to uphold trust in their field.

Auditors are required to ensure prompt disclosures within relevant sections and to the appropriate authorities, as well as in the Audit Report, to maintain stakeholders' trust. To fulfil these responsibilities, auditors must continuously refine their skills and critically assess assumptions and exercise professional skepticism to detect and assess fraud effectively.

Furthermore, management is expected to enhance internal controls by demonstrating vigilance and ethical standards to mitigate fraud risks. Collaboration with auditors should be encouraged to strengthen controls, improve fraud detection, and ensure compliance reporting, thus preventing malpractices.

Decoding the complexities in measurement and recognition under Ind AS 37-Provisions, Contingent Liabilities and Contingent Assets

Introduction

The objectives of this Standard are

- to ensure that appropriate recognition criteria is applied to provisions, contingent liabilities and contingent assets
- to ensure that appropriate measurement bases are applied to provisions, contingent liabilities and contingent assets and
- sufficient information is disclosed in the notes to enable users to understand their nature, timing and amount.

Ind AS 37 applies to all entities for accounting provisions, contingent liabilities, and contingent assets, except for certain exclusions:

- Provisions, contingent liabilities, and contingent assets resulting from **executory contracts** unless they are **onerous.**
  - Executory contracts- Contracts under which parties not/partly performed their obligations.
  - Onerous contracts-Unavoidable cost>Economic benefits
- Items covered by other standards such as Ind AS 12 (Income Taxes), 19 (Employee Benefits), 104 (Insurance Contracts), 103 (Business Combinations), 115 (Revenue from Contracts with Customers), and 116 (Leases) unless the lease or contract is onerous under Ind AS 115 or 116.
- Financial instruments covered by Ind AS 109 (Financial Instruments).
- Depreciation, impairment of assets, and doubtful debts.

Key Terms

- A contingent liability is an obligation that may arise from past events, contingent upon uncertain future events beyond the entity's control, or an existing obligation not recognized due to low probability of outflow or unreliable measurement.
- A contingent asset is a potential asset arising from past events, realization dependent on uncertain future events. Continuous evaluation ensures accurate reflection in financial statements. Recognition occurs when it's virtually certain that economic benefits will be received.
- Liability: is a present obligation of an entity arising from past events, the settlement of which is expected to result in an outflow of resources embodying economic benefits.
- Provision: is a liability of uncertain timing or amount.

Likelihood	Outflow of resources	Inflow of resources
Remote	Do nothing	Do nothing
Possible	Contingent liability	Do nothing
Probable	Provision	Contingent asset
Virtually certain	Provision	Asset

Recognition

- Provisions:
  - Recognized when:

    a. there's a present obligation due to a past event,

    b. it's probable an outflow of resources will be required, and

    c. the amount can be reliably estimated.
  - In rare cases of unclear present obligations, recognition is based on evidence indicating a likelihood of existence.
  - Past events leading to present obligations are obligating events, which may arise from enforceable legal actions or constructive expectations.
  - Only obligations from past events independent of future actions are recognized as provisions.
  - An event may not immediately give rise to an obligation but may do so later due to changes in law or entity's actions.
  - Probable outflows are determined by considering the likelihood of occurrence being greater than non-occurrence.
  - Reliable estimation of obligations is essential; extremely rare cases where no reliable estimate exists are disclosed as contingent liabilities.

Recognition Test: Provisions Estimate of the Obligation

RECOGNISE: If an entity will be able to determine a range of possible outcomes and can therefore make an estimate of the obligation that is sufficiently reliable to use in recognising a provision

Reliable Estimate

DISCLOSE : If an extremely rare case, where no reliable estimate can be made, such a liablitiy cannot be recognised and disclosed as a contigent liability.

- Contingent Liabilities:
  - Not recognized; disclosed unless the possibility of outflow is remote.
  - Jointly and severally liable obligations are treated partially as contingent liabilities, with provisions recognized only where outflows are probable.
- Contingent Assets:
  - Not recognized; disclosed unless the inflow of economic benefits is probable.
  - Continuously assessed; recognized when virtually certain of inflow, disclosed when probable.

Hence, provisions are recognized under specific conditions, contingent liabilities are disclosed, and contingent assets are not recognized but disclosed if inflow is probable, with continuous assessment for appropriate reflection in financial statements.

Measurement

- Best Estimate: Amount recognized as a provision shall be best estimate of the expenditure required to settle the present obligation at the end of the reporting period
- Principles for determining best estimates
- Best estimate of the expenditure required to settle present obligation is the amount that an entity would r**ationally pay** to settle the obligation at the end of the reporting period or to transfer it to a third party at that time.
- The estimates of outcome and financial effect are determined:
  - by the **judgement** of the management of the entity.
  - supplemented by **experience of similar transactions** and,
  - in some cases, **reports from independent experts.**
- **Provision for large population of items -** Obligation is estimated by weighting all possible outcomes by their associated probabilities. Such statistical method is named as "expected value"
- **Provision for single obligation -** Obligation is estimated at the most likely outcome.
- Provision is measured before tax.
- Risk and Uncertainties
  - The risks and uncertainties that inevitably surround many events and circumstances shall be taken into account in reaching the best estimate of a provision

- Future Events
  - Future events that may affect the amount required to settle an obligation shall be reflected in the amount of a provision where there is sufficient objective evidence that they will occur.
- Expected disposal of assets
  - Gains from the expected disposal of assets shall not be taken into account in measuring a provision, even if the expected dis is closely linked to the event giving rise to the provision.

Nangia's Take

Ind AS 37 is useful for several reasons:

- **Transparent Financial Reporting:** It ensures that entities accurately report their financial positions by recognizing provisions, contingent liabilities, and contingent assets when appropriate. This transparency helps stakeholders make informed decisions.
- **Consistency:** It provides a standardized framework for recognizing and measuring provisions, contingent liabilities, and contingent assets, promoting consistency across different entities and industries.
- **Risk Management:** By requiring entities to recognize potential liabilities and assets arising from uncertain future events, Ind AS 37 helps in identifying and managing risks effectively.
- **Accurate Financial Planning:** Recognition of provisions allows entities to anticipate and budget for future expenses, contributing to more accurate financial planning and forecasting.
- **Improved Decision Making:** By providing relevant information about potential liabilities and assets, Ind AS 37 enables management and investors to make better decisions regarding resource allocation, investment, and strategic planning

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