

भारत सरकार / Government of India
राष्ट्रीय वित्तीय रिपोर्टिंग प्राधिकरण / National Financial Reporting Authority

7th Floor, Hindustan Times House,
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सातवीं मंजिल, हिंदुस्तान टाइम्स हाउस,
कस्तूरबा गांधी मार्ग, नई दिल्ली
दिनांक: 13.04.2023

मिसिल संख्या : NF-23/14/2022

ORDER

In the matter of CA Lavitha Shetty, under Section 132(4) of the Companies Act 2013.

- 1 This Order disposes of the Show Cause Notice ('SCN' hereafter) number NF-23/14/2022 dated 3rd November 2022, issued to CA Lavitha Shetty (ICAI Membership no- 220473), proprietor of M/s Lavitha & Associates (ICAI Firm registration no. 011882S), Chikkamgaluru, who is a member of the Institute of Chartered Accountants of India ('ICAI' hereafter) and was the Engagement Partner ('EP' or 'the Auditor' hereafter) for the statutory audit of Mysore Amalgamated Coffee Estates Limited, Chikkamgaluru, for the Financial Year ('FY' hereafter) 2018-19.
- 2 This Order is divided into the following sections:
 - A. Executive Summary
 - B. Introduction & Background
 - C. Major lapses in the audit: Failure in audit relating to fraudulent diversion of funds and related matters
 - D. Other non-compliances with Laws and Standards
 - E. Articles of Charges of Professional Misconduct by the Statutory Auditor
 - F. Penalty & Sanctions.

A. EXECUTIVE SUMMARY

- 3 Pursuant to Securities and Exchange Board of India ('SEBI' hereafter) sharing in April 2022 its investigation regarding diversion of funds worth Rs 3,535 crores from seven subsidiary companies of Coffee Day Enterprises Limited ('CDEL' hereafter), a listed company, to Mysore Amalgamated Coffee Estate Limited ('MACEL' or 'the company' hereafter), an entity owned and controlled by the promoters of CDEL, NFRA initiated investigations under Section 132(4) of the Act.
- 4 NFRA's investigations inter alia revealed that the MACEL's Auditor for the FY 2018-19 failed to meet the relevant requirements of the Standards on Auditing ('SA' hereafter) in a number of significant aspects and demonstrated a serious lack of competence. The EP failed to exercise professional judgement & professional skepticism during audit of fraudulent borrowing of Rs 4,076.46 crores from Banks & Related Parties and use of such borrowed funds for fraudulent diversion of Rs 3,858.52 crores to personal accounts of promoters, their relatives, entities controlled by them and other related parties. The EP failed to exercise professional skepticism

during audit of related party balances involving an accounting fraud of Rs 2,363.34 crores, which resulted in understatement of related party loan balances by Rs 1,713.74 crores in the Financial Statements of MACEL. This accounting fraud was orchestrated by issue of cheques by MACEL at the year-end without adequate bank balance or bank credit limit, with the ulterior motive to conceal huge amount of related party balances. These cheques were cleared in the subsequent year i.e., FY 2019-20 by evergreening of loans through structured circular transactions of funds among Coffee Day Group Companies/Entities. The EP failed to evaluate the recoverability of loans of Rs 3,235.16 crores made to V. G. Siddhartha (the then Chairman and Managing Director of Coffee Day Enterprise Limited), his wife Mrs. Malavika Hegde and entities controlled by them. The EP failed to exercise professional skepticism during the audit of inappropriate recognition of finance cost of Rs 55.38 crores despite the fact that the corresponding borrowing was not used for any business purpose of MACEL. The EP failed to perform sufficient and appropriate audit procedure during audit of Cash Flow Statement, which had material misstatement of Rs 909.99 crores. The EP failed to evaluate issuance of corporate guarantees by MACEL and creation of charges on the assets of MACEL to facilitate borrowings of Rs 130 crores taken by wife of VGS and one other related party. Thus, despite material and pervasive misstatement of Rs 11,393.69 crores in the Financial Statements of MACEL, the EP falsely reported that such Financial Statements gave true and fair view of its financial position, financial performance and cash flow.

- 5 The EP falsely reported that MACEL had an effective system of Internal Financial Control over Financial Reporting despite complete absence of the same as pre-signed blank cheques were used for diversion of funds and fraudulent understatement of related party balances. The EP wrongly reported that MACEL was not required to be registered under section 45 IA of The Reserve Bank of India Act 1934 despite the fact that the principal business of MACEL had changed from coffee grower to Non-Banking Finance Company on account of diversion of funds. Besides these, the EP violated a number of Standards on Auditing and also failed to report violation of Accounting Standards by MACEL.
- 6 Based on investigation and proceedings under section 132 (4) of the Companies Act and after giving her opportunity to present her case, NFRA has found the EP guilty of professional misconduct and imposes through this Order the following monetary penalties and sanctions with effect from a period of 30 days from issuance of this Order:
 - a) Imposition of a monetary penalty of Rs Five Lakhs only upon CA Lavitha Shetty;
 - b) In addition, CA Lavitha Shetty is debarred for a period of five years from being appointed as an auditor or internal auditor or from undertaking any audit in respect of financial statements or internal audit of the functions and activities of any company or body corporate;

B. INTRODUCTION & BACKGROUND

- 7 National Financial Reporting Authority is a statutory authority set up u/s 132 of the Companies Act 2013 ('Act' hereafter) to monitor implementation and enforcing compliance of the auditing and accounting standards and to oversee the quality of service of the professions associated with ensuring compliance with such standards. NFRA has the powers of a civil court and is

empowered u/s 132 (4) of the Act to investigate into professional and other misconducts of auditors of the prescribed classes of companies¹ and impose penalty for proved professional or other misconduct of the individual members or firms of Chartered Accountants.

- 8 The Statutory Auditors, individuals and firms of Chartered Accountants, are appointed by the members of companies as per the provisions of section 139 of the Act. The Statutory Auditors, including the Engagement Partners and the Engagement Team that conduct the Audit are bound by the duties and responsibilities prescribed in the Act, the Rules made thereunder, the Standards on Auditing ('SA' hereafter), including the Standards on Quality Control and the Code of Ethics, the violation of which constitutes professional misconduct or other misconduct, and is punishable with penalty prescribed u/s 132 (4) (c) of the Act.
- 9 On receipt of information from SEBI vide letters dated 01.04.2022 & 29.04.2022 sharing its investigation regarding diversion of funds worth Rs 3,535 crores (as on 31-07-2019) from seven subsidiary companies of Coffee Day Enterprises Limited, a listed company, to Mysore Amalgamated Coffee Estate Limited, an entity owned and controlled by the promoters of CDEL, NFRA started investigation into the role of the statutory auditor under its powers in terms of section 132 (4) of the Companies Act 2013.
- 10 Late V. G. Siddhartha ('VGS' hereafter) was Chairman & Managing Director of CDEL till 29.07.2019. VGS and his family reportedly owned around 10,000 acres of coffee estates through various entities owned by VGS and operated and managed by MACEL, whose 91.75% shares were held by Late S.V. Gangaiah Hegde, the father of VGS.
- 11 As per the investigations made by SEBI, the outstanding balance payable by MACEL to subsidiary companies of CDEL was Rs 842 crores as on 31 March 2019, which increased to Rs 3,535 crores on 31 July 2019, detailed as under in Table 1-

Table-1 (Rs in crores)

Sr. No.	Names of the Subsidiary Companies from which funds were diverted to MACEL	Outstanding balance as on	
		March 31, 2019	July 31, 2019
1	Coffee Day Global Ltd (CDGL)	65	1,112
2	Tanglin Retail Reality Developments Pvt Ltd (TRRDPL)	789	1,050
3	Tanglin Developments Ltd (TDL)	(-) 12	620
4	Giri Vidhyuth (India) Ltd. (GVIL)	-	370
5	Coffee Day Hotels and Resorts Pvt Ltd (CDH&RPL)	-	155
6	Coffee Day Trading Ltd (CDTL)	-	125
7	Coffee Day Econ Pvt Ltd (CDEPL)	-	103
Total		842	3,535

- 12 As per the Financial Statements of MACEL, Rs 3,535 crore was further transferred from MACEL to the personal accounts of VGS, his relatives and entities controlled by him and/or his family

¹ Rule 3 of The NFRA Rules 2018.

members, whose outstanding balances receivable were Rs 3,238.95 crores as on 31-03-2019. On examination of the Financial Statements of MACEL, it transpired that MACEL did not have any business transactions with 6 of the 7 subsidiary companies except CDGL. It was also transpired that MACEL was used as a conduit to transfer funds from subsidiaries companies of CDEL to the personal accounts of VGS, his relatives and entities controlled by him and/or his family members, as loans and advances that were never returned to MACEL/CDEL.

- 13 The modus operandi of the alleged diversion of funds discovered during the SEBI investigation was that *“VGS used to ask the Authorised Signatories to sign a bunch of cheques which were kept in his possession and used them as and when required”*. Such pre signed blank cheques of bank accounts of various Coffee Day Group companies were used for the diversion of funds.
- 14 This order deals with the role of the Auditor of MACEL, which was owned by father of VGS (the then Chairman & Managing Director of CDEL). MACEL is engaged in agricultural activities in the state of Karnataka, India. MACEL had around 578 acres of Coffee plantations besides some plantations of Paper, Areca etc. It has office at Chikkamagaluru, a district headquarters in Karnataka.
- 15 Rule 3 of The National Financial Reporting Authority Rules 2018 (‘NFRA Rules 2018’ hereafter) lists out the classes of companies and body corporates governed by NFRA. This includes unlisted Public Companies having paid-up capital of not less than rupees five hundred crores or having annual turnover of not less than rupees one thousand crores or having, in aggregate, outstanding loans, debentures and deposits of not less than rupees five hundred crores as on the 31st March of immediately preceding financial year. MACEL, an unlisted Public Company having borrowings of Rs 2,791.89 crore as on 31.03.2018, falls under the jurisdiction of NFRA for FY 2018-19 and its financial statements are to be prepared in accordance with Accounting Standards and the relevant Laws.
- 16 NFRA called from the statutory auditor the Audit File of MACEL for Financial Year (‘FY’ hereafter) 2018-19 to examine the role of the auditor and for investigation under section 132(4)(b)(i) of the Act. Based on an examination of the Audit File and other materials on record, NFRA issued a Show Cause Notice (‘SCN’ hereafter) to the Auditor on 03.11.2022 asking the Auditor to show cause by 03.12.2022 why penal provisions of section 132(4)(c) of the Companies Act 2013 should not be invoked for professional misconduct of:
 - a) Failure to disclose a material fact known to the EP which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where the Statutory Auditor is concerned with that financial statement in a professional capacity.
 - b) Failure to report a material misstatement known to the EP to appear in a financial statement with which the Statutory Auditor are concerned in a professional capacity.
 - c) Failure to exercise due diligence and being grossly negligent in the conduct of professional duties.
 - d) Failure to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion, and
 - e) Failure to invite attention to material departure from the generally accepted procedures of audit applicable to the circumstances.

- 17 The Auditor sought 30 days extension of time for submitting response to SCN. Extension of time was allowed for 15 days. After availing the extension of time, the Auditor vide letter dated 18.12.2022 submitted a reply to the SCN.
- 18 M/s Lavitha & Associates is a proprietary firm registered with the ICAI carrying on the profession of chartered accountancy from Chikkamgaluru city in the state of Karnataka. The Audit Firm was the Statutory Auditor of MACEL for FY 2018-19 and CA Lavitha Shetty was the Engagement Partner for this audit engagement. The Firm was also Statutory Auditor of Coffee Day Hotels & Resorts Private Limited, a Coffee Day Group company, for FY 2018-19.
- 19 The SCN gave an opportunity of personal hearing to the Auditor, which she did not avail. Accordingly, this Order is based on examination of the facts of the matter, charges in the SCN, written replies of the Auditor and other materials available on record.

C. MAJOR LAPSES - FAILURE IN AUDIT RELATING TO FRAUDULENT DIVERSION OF FUNDS AND RELATED MATTERS

C.1 Failure in understanding the nature of business of MACEL resulting in lapses in audit relating to fraudulent diversion of funds

- 20 The Auditor was charged² with failure to obtain an understanding of the nature of MACEL including its operations, its ownership and governance structures, the types of investment the entity was making and how it was financed, in order to understand the classes of transactions and account balances. The Auditor was also charged with failure to exercise Professional Judgment and Professional Skepticism in planning and performing the audit of the Financial Statements of MACEL³. Had the Auditor obtained understanding of MACEL, exercised Professional Judgment & Professional Skepticism, and performed sufficient appropriate audit procedure, she would have detected and reported material and pervasive misstatements in the financial statements of Rs 3,858.52 crores on the Assets side and Rs 4,076.46 crores on the Liability side of the Balance Sheet. These misstatements were the result of fraudulent borrowing by MACEL mainly from related parties, which were used for fraudulent lending to promoters, their family members and entities owned/controlled by them.
- 21 MACEL received funds from seven subsidiary companies of CDEL despite the fact that it did not have any business relationship with subsidiary companies of CDEL except CDGL, the sole buyer of Coffee beans produced by MACEL. As per the Financial Statements of MACEL for

² See para 11(b) of SA 315, Identifying and assessing the risk of material misstatement through understanding the entity and its environment.

³ Para 16 of SA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing, provides that 'The auditor shall exercise professional judgment in planning and performing an audit of Financial Statements. Para 13 (k) of SA 200 defines Professional Judgement as 'The application of relevant training, knowledge and experience, within the context provided by auditing, accounting and ethical standards, in making informed decisions about the courses of action that are appropriate in the circumstances of the audit engagement'. Professional skepticism is defined at para 13(l) of SA 200 as – 'An attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence'. Para 15 of SA 200 provides that 'The auditor shall plan and perform an audit with professional skepticism recognising that circumstances may exist that cause the financial statements to be materially misstated'.

2018-19, its borrowings of Rs 4,112.47 crores constituted 99.86% of total liabilities of Rs 4,118.18 crores, while 99.07% of its total assets of Rs 3,894.53 crores were the loans & advances worth Rs 3,858.52 crores. MACEL had meagre Revenue from operations of Rs 1.71 crores & interest income of Rs 2.33 crores only but its Finance cost on borrowings was Rs 55.38 crores which constituted 90.89% of the total cost of Rs 60.93 crores. The loss incurred by MACEL during the year was Rs 56.89 crores and MACEL had a negative net worth of Rs 223.65 crores. All the above stated borrowings (except bank borrowings of Rs 272.32 crores) and lending were interest free, repayable on demand and not supported by any Contract/Agreement. The Financial Statements of MACEL indicated that it had abnormally high transactions in loans & advances and balances with related parties, which were outside the normal course of business of the company, strongly indicating that MACEL was being misused by the promoters for diversion of funds from subsidiary companies of CDEL to promoters, their family members and entities controlled by them.

- 22 The financial statements indicated that majority of the related party borrowings were from subsidiary companies of CDEL (Table 2) and were further diverted to the personal accounts of promoter, their family members and entities controlled by them (Table 3).

Table-2

Rs in crores

MACEL's borrowings from subsidiary companies of CDEL (Related Parties)				
Sr No	Name of company from whom funds were borrowed	Balance as on 31.03.2019 as per FS of MACEL	Balance reduced fraudulently* by issuing cheques without adequate balance in the account	Total outstanding as on 31.03.2019
(1)	(2)	(3)	(4)	(5 3+4)
1	Tanglin Retail Realty Development Pvt Ltd	789.35	685.01	1,474.36
2	Coffee Day Global Ltd	64.82	222.50	287.32
3	Tanglin Development Ltd	-11.68	474.00	462.32
4	Coffee Day Trading Ltd	0	125.00	125.00
5	Coffee Day Hotels & Resorts Pvt Ltd	0	150.00	150.00
6	Giri Vidhyut (India) Ltd	0	50.00	50.00
	Total	842.49	1,706.51	2,549.00

(Note-* Borrowings from related parties were fraudulently understated by issue of cheques in March 2019 showing repayment of related party loans without having adequate bank balance or approved bank credit limit. These cheques were cleared in FY 2019-20 by evergreening of loans through structured circulation of funds among related parties. Details of fraudulent understatement of loans and evergreening of loans are discussed in subsequent charges).

Table-3

Name of promoter's family members to whom loans were given by MACEL	Rs in crores
V G Siddhartha (VGS), Malavika Hegde (wife of VGS) & partnership firm in which he/she is a partner	3,235.16
S V Gangaiah Hegde (Father of VGS)	2.31
Vasanthi Hegde (Mother of VGS)	1.48
Total	3,238.95

- 23 It can be observed from Tables-2 & 3 above that loans & advances taken by the company were not for the business activities of the company, but were used for onward lending to the related parties, mainly promoters. Out of the total assets of Rs 3,894.53 crores, only Rs 36.01 crores appear to have been used for business activity, and remaining Rs 3,858.52 crores (99.07% of total assets) were given as Loans & Advances, which was not in the normal course of business of MACEL, but were used for diversion of funds, resulting in material and pervasive misstatement on the Assets side of the Balance Sheet.⁴ Similarly, out of the total liabilities of Rs 4,118.18 crores, borrowings accounted for Rs 4,112.47 crores (99.86%). Keeping in mind that only Rs 36.01 crores were used for business activity, the rest of the borrowings of Rs 4,076.46 crores (4,112.47 crores -36.01 crores), i.e., 99.12% of total borrowings were used for diversion of funds resulting in material and pervasive misstatement on the Liability side of the Balance Sheet. There was no business rationale in such borrowing and lending transactions with group companies and it is evident from Table 2 & 3 above that MACEL was used as a conduit to create an intermediate layer with the ulterior motive to mislead stakeholders and regulators, and fraudulently divert funds to the personal accounts of promoters, their relatives and entities controlled by them.
- 24 As per para 5 of SA 315, the Auditor was required to perform risk assessment procedures to provide a basis for the identification and assessment of Risks of Material Misstatement (RoMM) at the financial statements and assertion levels. As per para 5 of SA 330⁵, the Auditor was required to respond to the assessed RoMM by performing appropriate audit procedures. In light of the fact that such huge borrowings and lendings involving related parties went unnoticed in audit, as there is no evidence in the Audit File that the Auditor had performed such procedures to identify RoMM due to suspected fraudulent diversion of funds, the SCN charged the Auditor with failure to identify and respond to the RoMM in non-compliance with SA 315 & 330.

⁴ The term Material is referred in AS 25, Interim Financial Reporting, as, 'information is material if its misstatement (i.e., omission or erroneous statement) could influence the economic decisions of users taken on the basis of the financial information'.

The term Misstatement is defined in para 13(i) of SA 200 as, "A difference between the amount, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud".

The term Pervasive is defined in para 5(a) of SA 705, Modifications to the Opinion in the Independent Auditor's Report, as, "A term used, in the context of misstatements, to describe the effects on the financial statements of misstatements or the possible effects on the financial statements of misstatements, if any, that are undetected due to an inability to obtain sufficient appropriate audit evidence. Pervasive effects on the financial statements are those that, in the auditor's judgment:

(i) Are not confined to specific elements, accounts or items of the financial statements;
(ii) If so confined, represent or could represent a substantial proportion of the financial statements; or
(iii) In relation to disclosures, are fundamental to users' understanding of the financial statements".

⁵ SA 330, Auditors Response to Assessed Risk.

- 25** SA 240 prescribes auditor's responsibilities relating to fraud in audit of financial statements. Para 10 of SA 240 provides that the objectives of the auditor are to identify and assess the RoMM in the Financial Statements due to fraud, obtain audit evidence and respond to identified or suspected risk. Para 12 of SA 240 requires the auditor to maintain professional skepticism recognizing the possibility of existence of material misstatement due to fraud. Para 32 (c) of SA 240 further requires the auditor to evaluate the business rationale (or lack thereof) of the significant transactions that are outside the normal course of business or otherwise appear unusual and evaluate whether such transactions may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of funds.
- 26** The Audit File has a letter dated 30.05.2019 from a director of MACEL admitting that funds were received from group entities for development and maintenance of coffee plantations. The funds were payable on demand but no agreements had been signed. In respect of loans and advances given to group entities, he had admitted that the loans were payable on demand, that no agreements were signed and the account of the group was being maintained as a running account. These admissions, together with the financial information in Table-3, are strong indicators of fraudulent diversion of funds. Noting that had the Auditor applied professional judgment and skepticism to the admitted facts that no agreements were signed for the financial arrangements involving substantial funds, huge sum of loans were payable on demand, the group accounts were maintained as running account; and the management letter, she would have assessed the RoMM as high and designed & performed appropriate audit procedures. The SCN charged the Auditor with non-compliance with SA 240.
- 27** The Auditor's above-mentioned lack of due diligence and gross negligence was also a violation of section 143 (12) of the Act under which the Auditor had the statutory duty to report the offence of fraud to the Central Government. However, the Auditor had reported⁶ that no material fraud by or on the company had been noticed or reported during the course of audit. This was also a violation of the Companies (Auditors Report) Order 2016 ('CARO' hereafter), as the Auditor had ignored the strong indicators of fraud including the receipt and disbursement of loans & advances without any business rationale, complete absence of internal control and violation of the provisions of the Act. The Auditor knew that funds were being diverted to personal accounts of promoters, their relatives and entities controlled by them and that MACEL was being used only to create an intermediate layer with the ulterior motive to mislead stakeholders and regulators while fraudulently diverting funds to personal accounts of promoters, their relatives and entities controlled by them.
- 28** MACEL, in its Extra-ordinary General Meeting ('EGM' hereafter) held on 13.02.2019, had passed two special resolutions authorizing the Board of Directors to borrow money up to Rs 6,000 crores under section 180(1)(c) of the Act and to make investment and grant loans up to Rs 6,000 crores under section 186 of the Act. There was no evidence in the Audit File that in compliance with the above EGM resolution, the Board of Directors had approved any resolution for borrowing and making loans & advances, as required under section 179(3) of the Act. There was also no evidence in the Audit File regarding the approval of Members of the company and

⁶ Para X of Annexure -A (CARO report) of Independent Auditor report dated 05-06-2019.

Board of Directors in respect of funds borrowed and funds given as loans & advances prior to 13.02.2019. The Auditor was therefore charged with failure to verify whether MACEL had complied with the provision of sections 179(3), 180(1)(c) and 186 of the Act.

- 29** Diverting funds fraudulently to the personal accounts of promoter, his relatives and entities controlled by him and/or his family members is covered in section 420 of the Indian Penal Code⁷, which is a Predicate Offence for money laundering under section 3 of the Prevention of Money Laundering Act 2002 ('PMLA' hereafter)⁸. The SCN charged that the Auditor did not report this violation in the Independent Auditor's Report and also did not consider its impact on the Financial Statements while making audit conclusions and therefore charged to have violated SA 250⁹.
- 30** The Auditor was also charged with failure to evaluate recoverability of loans worth Rs 3,235.16 crores made to VGS (the then Chairman & Managing Director of CDEL), his wife Mrs. Malavika Hegde and entities controlled by them ('VGS & Others' hereafter) resulting in non-compliance with section 143(3)(e) of the Act and SA 500, Audit Evidence.
- 31** As per Accounting Standard (AS) 4¹⁰, which deals with Contingencies and events occurring after the Balance Sheet date, MACEL was required to assess the recoverability of loans given to VGS & Others, however, MACEL did not do so. Further, MACEL had neither provided any probable loss on account of impairment of these loans nor disclosed anything about this matter in the Financial Statements. Thus, MACEL violated AS 4.
- 32** The Auditor had observed that MACEL was facing huge mismatch in short term payables with short term receivables. Director of MACEL replied vide letter dated 30.05.2019 that this was a temporary phenomenon and the company was confident of sorting out the issue and it could not impact on the liquidity crunch. He had attached net worth certificate of VGS issued by M/s Sundaresha & Associates vide letter dated 05.03.2019 certifying net worth of VGS as Rs

⁷ Section 420 of IPC states, 'Whoever cheats and thereby dishonestly induces the person deceived to deliver any property to any person, or to make, alter or destroy the whole or any part of a valuable security, or anything which is signed or sealed, and which is capable of being converted into a valuable security, shall be punished with imprisonment of either description for a term which may extend to seven years, and shall also be liable to fine.

⁸As per section 3 of PMLA act 2002, 'Whosoever directly or indirectly attempts to indulge or knowingly assists or knowingly is a party or is actually involved in any process or activity connected with the proceeds of crime including its concealment, possession, acquisition or use and projecting or claiming it as untainted property shall be guilty of offence of money-laundering'. 'Proceeds of Crime', as defined at section 2 (u) of PMLA Act, means any property derived or obtained, directly or indirectly, by any person as a result of criminal activity relating to a scheduled offence. List of schedule offences in Part A of the schedule under PMLA Act 2002, covers section 420 of Indian Penal Code i.e., 'Cheating and dishonestly inducing delivery of property'.

⁹ SA 250, Consideration of Laws and Regulations in an Audit of Financial Statements.

¹⁰ As per footnote 1 to AS 4, "the impairment of financial assets such as impairment of receivables (commonly known as provision for bad and doubtful debts) is governed by this Standard". Loans being financial assets are covered in this standard. Para 5.1 of AS 4 provides "The accounting treatment of a contingent loss is determined by the expected outcome of the contingency. If it is likely that a contingency will result in a loss to the enterprise, then it is prudent to provide for that loss in the financial statements". As per para 10 of AS 4, "The amount of a contingent loss should be provided for by a charge in the statement of profit and loss if (a) it is probable that future events will confirm that, after taking into account any related probable recovery, an asset has been impaired or a liability has been incurred as at the balance sheet date, and (b) a reasonable estimate of the amount of the resulting loss can be made". As per para 11 of AS 4, "The existence of a contingent loss should be disclosed in the financial statements if either of the conditions in paragraph 10 is not met, unless the possibility of a loss is remote".

2,485.40 crores as on 31.03.2018. The reply of MACEL was not specific and also did not cover the entire outstanding loans of Rs 3,235.16 crores as the certified net worth was only Rs 2,485.40 crores leaving a shortfall of Rs 749.76 crores. The Auditor had relied on this certificate without any evaluation of recoverability of loans of Rs 3,235.16 crores.

- 33 As per para 8 of SA 500¹¹, the Auditor was required to evaluate the competence, capabilities and objectivity of M/s Sundaresha & Associates (management expert) which issued the net worth certificate dated 09.03.2019, obtain an understanding of the work of expert and evaluate the appropriateness of net worth certificate as audit evidence. However, examination of the Audit File shows that no such audit procedures were performed. Even the net worth certificate does not contain all annexures and hence was incomplete. It appears that the Auditor did not exercise due diligence while evaluating the recoverability of these loans. Thus, the Auditor was charged to have violated SA 500 and section 143(3)(e) of the Act as she had reported that Financial Statements comply with the Accounting Standards.

Reply of the Auditor

- 34 While denying the charge, the Auditor has stated that charge of diversion of funds was a misinterpretation drawn in the backdrop of death of VGS and was an ex post facto analysis. According to her, CDEL is a respected group and the Auditor had no reasons to suspect honesty, integrity and ability of the management.
- 35 The Auditor further stated that she had obtained reasonable understanding about the nature of the entity and its operations; that audit evidence are available at page no 170 to 195 of the Audit File forming part of Annexure to SCN; that she obtained audit evidence regarding amount received from group companies and advances granted to other group entities and the same was available at point 2 & 3 of page 28 of the Audit File forming part of Annexure to SCN. The Auditor replied that the transactions in question were undertaken according to the business wisdom and judgement of the management. However, after the death of VGS, discovery of facts suggested that he seemed to have erred in his business calculations. These aspects were incapable of being forecast by an auditor at the time of audit. The Auditor stated that such transactions were carried out without any agreement between the parties, accounts were maintained as a running account and were payable/receivable on demand.
- 36 In respect of compliance with SA 200, SA 315 & SA 330, the Auditor replied that she had performed necessary audit procedures to understand the entity and to identify RoMM. However, after performing audit procedures, no RoMM was identified or assessed. (She referred to page no- 165-166, 169, 194-195 and 202 the Audit File forming part of Annexure to SCN). She further replied that huge volumes of advances made to related parties and consequent outstanding balances as reflected in the Financial Statements did not pose any risk of material misstatements as these were the effect of actual transactions; that she had obtained fair knowledge of the entity, its environment, financial reporting system and internal controls in the past years audits; that, as mentioned in SCN, the business group had around 10000 acres of coffee plantations and MACEL had around 578 acres of coffee plantations. According to the Auditor, MACEL had impressed

¹¹ SA 500, Audit Evidence.

upon her that it played an important role in monitoring coffee plantations which were managed by the CCD group (Coffee Day Group) including those which were not under its direct ownership. Funds received from subsidiaries of CDEL were advanced to other group entities to administer the affairs of such coffee plantations; and she had no reason to disbelieve this position of MACEL management because it was a company as part of a respectable corporate group at that point of time. The Auditor argued that advances in contention were not diversion of funds but were for furtherance of the interest of the CDEL group for which the company itself funded monies through its subsidiaries. The Auditor admitted that *“Based on the information gathered by SEBI and NFRA subsequent to the death of Shri V G Sidhartha, there could be merit in the view of NFRA that advances granted by MACEL were not for business objectives. Certainly, it was not possible for the respondent to form any such conclusion at that point of time when respondent did the audit for 2018-19”*.

37 While not disputing the facts given in Table 2 & 3 regarding related party borrowings and advances made, the Auditor replied that she would not be able to agree or disagree with the narratives used in SCN that funds were diverted to personal accounts of promoter because such findings can emerge only from an investigation and are not capable of being detected within the scope of a Statutory Auditor.

38 While responding to the charge relating to failure to verify whether borrowings & lendings were approved by the Board of Directors in accordance with section 179(3) of the Act, the Auditor replied that there is no reporting obligation on auditor under section 179(3) & 180 of the Act, and the responsibility of providing reasonable assurance was duly discharged in this case and she also stated that:

“Kindly appreciate that the financial statements that are duly approved by the Board of Directors of the company is the evidence that all the transactions in it including the loans and advances both as assets and liabilities have the stamp of approval of the Board of Directors”.

39 Responding to the charge relating to non-compliance with SA 240, the Auditor replied that there has been no transaction outside the normal course of activities. The Books of Account and Financial Statements did not show any error or omission in the presentation of transactions in the Financial Statements. Giving advance to associate entities in furtherance of their business objectives cannot constitute any fraud. They were genuine recoverable amounts. She termed it as a case of liquidity crisis resulting from cash flow management which was under the control of VGS. It could be criticized as poor corporate governance but did not make it a fraudulent case. The Auditor further stated that the absence of agreement for advance transactions did not make it a case of transactions with fraudulent intentions.

40 Responding to the charge relating to non-compliance with section 143(12) of the Act, the Auditor replied that use of words *“if Auditorhas reason to believe....”* in section 143(12) of the Act means that expectation of law from the Auditor is not that she would detect every potential fraud and report. According to the audit conducted by her, no fraud or misappropriation of assets was observed. An auditor is not skilled to detect fraud. She further stated that the family of VGS,

holding 91% shares, carried out the transactions hence the issue was not about absence of internal control.

- 41 Responding to the charge relating to violation of PMLA, the Auditor replied that she had no knowledge that these transactions were fraudulent diversion of funds, and there were no findings by any Authority that such transactions fell within the definition of section 420 of IPC or section 3 of PMLA. The Auditor further stated that she had not observed violation of any law that posed threat of potential material misstatement in the FS of MACEL.
- 42 Responding to the charge relating to failure to evaluate recoverability of loans given to VGS & Others, the Auditor stated that she did not suspect any possible impairment losses from the advance given to VGS and Others, because as per the management, such advances were given for furtherance of business objectives spread in a large number of coffee plantations managed by the company. According to her, the difference in perception is because of events that happened after the audit of MACEL, which influenced the NFRA. She further stated that as per para 11 of AS 4, the case falls under the category of “remote possibility of loss, as per the judgement of the Auditor during the course of the audit.
- 43 Regarding the net worth certificate of VGS issued by M/s Sundaresha & Associates, the Auditor claimed that she did not feel the need of hundred percent coverage of advances from the net worth of VGS alone, because the funds were deployed in recoverable business assets, according to management explanations. Regarding competence & capabilities of the expert, the Auditor stated that M/s Sundaresha & Associates, being a respected CA firm with long and credible track record in the state of Karnataka, the Auditor did not require to follow any additional procedure to evaluate the capability of this CA firm. She further stated that as per para 6(c) of SA 620, M/s Sundaresha & Associates, being an audit and accounting firm, is not covered in the definition of Management’s expert. Therefore, para 8 of SA 500 regarding evaluation of the competence, capabilities and objectivity of M/s Sundaresha & Associates (management expert), as mentioned in the SCN, is not applicable in this case.

Analysis of reply

- 44 We have considered the reply of the Auditor. MACEL’s revenue from operations was Rs 1.71 crores in 2018-19, it had tangible assets of Rs 36.01 crores and negative net worth of Rs 223.65 crores. It did not have any expansion plan. Accordingly, there is no doubt that MACEL did not need huge borrowings of Rs 4,112.47 crores and lending of Rs 3,858.52 crores for its business purpose. The Auditor has admitted that during the audit for FY 2018-19, she had completely relied upon management explanations that huge amounts of borrowings from related parties and lending to related parties were for furtherance of coffee business of the associated entities. MACEL was not a financial institution therefore routing of such huge amounts through it cannot be considered as transactions in the ordinary course of business of MACEL, as it did not have any business relationship with the said associated entities. Therefore, before relying on the management explanation, the Auditor was required to evaluate the business purpose behind such huge borrowings and lending transactions with related parties, which was not done.

- 45 The Audit work papers quoted by the Auditor have been perused. Page 165-167 of the Audit File is a certified copy of resolution passed in EGM authorising the Board of Directors to borrow and lend money up to Rs 6,000 crores. However, pursuant to the EGM resolution, the Board of Directors did not pass any resolution for approval of the borrowings and lending transactions, which were undertaken by MACEL. Section 179(3) of the Act empowers the Board of Directors ('Board' hereafter) to exercise powers relating to borrowing and lending of money, by means of a resolution passed at meetings of the Board. Mandatory provision of passing a resolution at meetings of the Board shows the importance of these transactions in the operations of a company. The obvious purpose of making such provision is to ensure that no unauthorized borrowings and lending transactions are entered into by the company management. In this case the EGM authorised the Board to take decisions on borrowings and lendings up to a monetary limit. But the Board made no such authorisation, rendering these huge borrowings and lendings as unauthorised. Further, section 179(3) of the Act is independent of section 134(1) of the Act, which inter alia provides that financial statements shall be approved by the Board of Directors. The reply of the Auditor that the approval of financial statements by the Board of Directors of the company is evidence that all the transactions in it have the stamp of approval of the Board of Directors is astonishing and reflects a total lack of understanding of what an 'authorisation of transaction' by the Board means. Such a flawed understanding by the Auditor who is entrusted to check adherence to Standards and the Laws, is alarming and disconcerting. It appears that the Auditor has furnished this absurd reply to cover up her deficiency during performance of this Audit.
- 46 It is an undisputed fact that all borrowings and lendings were without any written Contract/Agreement and were repayable on demand. There is no material on record whether any security was obtained before giving such huge amounts of loans/advances. Despite knowing these adverse indicators, the Auditor did not evaluate business rationale of huge borrowing and lending transactions with related parties. Needless to say, every Auditor should be aware that related party transactions have high potential of misuse/misstatement, as is also reflected in special provisions in law to monitor and regulate them.
- 47 In view of above analysis, we find that the Auditor failed to examine and report that funds were being fraudulently borrowed from Banks & subsidiary companies of CDEL and were being fraudulently diverted to the personal accounts of promoters, their family members and entities owned/controlled by them.
- 48 The audit work papers relied upon by the Auditor as having details of performing risk assessment procedures have also been perused. Page 168 of the Audit File is a statement prepared by MACEL containing some basic details about the company like nature of business and operational heads of the company. Page 169 is a statement prepared by MACEL regarding assessment of risk in the area of sales, purchase, estate works and bank accounts. These documents do not contain any details about risk assessment procedure performed by the Auditor to identify, assess and respond to RoMM due to fraud. Page 170 to 193 contain information obtained from MACEL relating to shareholders list and Director's details and declarations. Page 194 & 195 contain Internal Financial Control Policy prepared by MACEL containing high level general information about segregation of duties, authorization & approval, custodial & security arrangement and

review & reconciliation. No specific information about these areas is mentioned in these documents prepared by MACEL. The Auditor has not evaluated these documents. Therefore, the contention of the Auditor of having performed risk assessment procedure is factually incorrect. Further, the Auditor replied that she was the Auditor of MACEL for years prior to FY 2018-19 also, therefore she had fair knowledge of the entity and its environment. In this connection, para 9 of SA 315 states that when the auditor intends to use information obtained from auditor's previous experience with the entity and from the audit procedures performed in previous audits, the auditor shall determine whether changes have occurred since the previous audit that may affect its relevance to the current audit. There is no record of such determination in the Audit File. Further, the Auditor was required to perform risk assessment procedure at the beginning of audit for FY 2018-19 to understand MACEL and to identify possible RoMM in the Financial Statements of FY 2018-19 as required under SA 315, which she failed to do.

- 49** The Auditor had admitted that she could not identify any RoMM during the course of the audit and did not assess and respond to any RoMM. This is an admission that she relied on management explanation only. She failed in her duty as she did not perform sufficient and appropriate audit procedure to identify, assess and respond to RoMM due to fraud. This is tantamount to turning a blind eye to the ruse that lay before her. With reference to the reply that diversion of funds can emerge only from an investigation and is not capable of being detected by a Statutory Auditor, it is relevant to mention that diversion of funds was evident from the Financial Statements and other information accessible to the Auditor as already analysed by us in the preceding paras. However, the Auditor did not exercise professional skepticism during the course of audit to identify, assess and respond to the RoMM. It is appropriate to note that SA 240 was issued in 2009, at least a decade ago before the date of this Audit, but the Auditor has displayed little understanding or application of this SA. We therefore find that the Auditor did not comply with SA 200, SA 240, SA 315 and SA 330.
- 50** In respect of the reply relating to non-compliance with section 143(12) of the Act that no agency has termed these transactions as fraudulent, we believe that action by NFRA is independent of any other agency. As already analysed by us, funds were fraudulently borrowed with the ulterior motive to divert funds to promoters without proper authority, without any business purpose, without Contract/Agreement and without obtaining any security. Therefore, this fraud could have been easily noticed by the Auditor. She failed to report this offence of fraud to the Government of India and thus violated section 143(12) of the Act. The Auditor has also violated CARO, as she reported that no fraud was noticed during the course of audit.
- 51** In respect of the Auditor's reply relating to violation of PMLA that as per her knowledge, these transactions were not fraudulent and there is no finding by any authority that such transactions fall within the definition of section 420 of IPC or section 3 of PMLA, it has already been discussed that the fraudulent diversion of funds were visible from the Financial Statements of MACEL. The Auditor was required to exercise professional judgement to identify fraudulent transactions and make audit report accordingly. Diversion of funds to personal accounts of promoters, their relatives and entities owned/controlled by them is clear proof of cheating and dishonesty, and thus falls under section 420 of IPC thereby attracting section 3 of PMLA. We

find that the Auditor has failed to report this violation in the audit report and has thus violated SA 250.

- 52 Loans/Advance given to VGS & others of Rs 3,235.16 crores was 83% of the total assets of MACEL i.e., Rs 3,894.53 crores. There was no contract/agreement for this transaction. It was important to evaluate the recoverability of these loans/advances, so that provision could have been created for non-recoverable portion of these loan/advance. This was essential to ensure that the Financial Statements of MACEL give a true and fair view of its financial position and financial performance.
- 53 The Auditor obtained a net worth certificate of VGS showing his net worth as Rs 2,485.40 crore issued by M/s Sundaresha & Associates. This net worth certificate has five chapters i.e., Background, Scope of Information, Methodology of Valuation of Assets (Coffee Plantations), Methodology of Valuation of Shares in Companies and Computation of Net Worth. Valuation of coffee plantations was done at fair market value, based on Agriculture and Valuation reports of Mr. P. K. Ramesh, registered valuer in respect of some plantations. Valuation of shares of listed companies i.e., CDEL, Mindtree Limited and SICAL Logistics Limited, was done on market price prevalent on 31.03.2018, valuation of shares of CDGL was done based on valuation report, valuation of shares of M/s Shankar Resources Private Limited was based on market price of its investment and valuation of shares of M/s Devadarshini Info Technologies Private Limited was done according to fair valuation model adopted by this company.
- 54 There is no evaluation of this net worth certificate in the Audit File. The net worth certificate available in the Audit File is of five pages and does not contain its annexures. The Auditor did not reply about the absence of annexures in the Audit File. It shows that the Auditor has simply obtained a copy of the net worth certificate and did not evaluate the appropriateness of the methodology used for computation of net worth. It shows that she did not exercise due diligence and did not perform sufficient and appropriate audit procedures before relying on this certificate.
- 55 Further, total net worth of VGS was Rs. 2,485.40 crore only leaving a shortfall of huge amount of Rs 749.76 crore in comparison to total loans of Rs 3,235.16 crores. For recovery of this shortfall, there is no material on record that funds were deployed in recoverable business assets, as claimed by the Auditor in her reply. There is no evaluation of recoverability of such business assets in the Audit File. Therefore, this part of the reply is an afterthought to cover up negligence during the conduct of the Audit.
- 56 As already discussed in preceding paras that funds were fraudulently diverted to 'VGS & Others' without any business objective of MACEL, which did not have any business relationship with VGS & Others. Therefore, there is no merit in the reply that funds were given for furtherance of business objectives of MACEL.
- 57 Para 11 of AS 4 states '*The existence of a contingent loss should be disclosed in the financial statements if either of the conditions in paragraph 10 is not met, unless the possibility of a loss is remote*'. The Auditor has stated that this case falls under the category of "remote possibility of loss", without substantiating this conclusion in the Audit File. Therefore, we find this reply is

also an afterthought to cover up her failure to evaluate recoverability of loans given to 'VGS & Others'.

- 58 Further, the Auditor did not evaluate the competence of the CA Firm which issued the net worth certificate. These are basic due diligence requirements expected from a statutory auditor as per SA 500. The Auditor cannot be allowed to escape her responsibility simply by saying that the issuer of net worth certificate is a respectable CA firm. Evaluation about competence and capability of management expert was to be done at the time of performing audit, which was not done.
- 59 Furthermore, 'Management expert' is defined in para 5(d) of SA 500 and 6(c) of SA 620 as "*An individual or organisation possessing expertise in a field other than accounting or auditing, whose work in that field is used by the entity to assist the entity in preparing the financial statements*". The Auditor's reply regarding definition of management expert is out of context as providing net worth certificate is neither accounting nor auditing service. It is a kind of valuation service. M/s Sundaresha & Associates, though a CA Firm, issued the net worth certificate as a valuation expert. Valuation certificates were also the basis of the net worth certificates. In the net worth certificate, many of the assets of VGS were valued at fair value, which is specialized area of valuation and not accounting & auditing job. Therefore, the Auditor was duty bound to evaluate competence and capability of M/s Sundaresha & Associates, besides the methodology and assumptions used in calculation of fair value of assets, which she failed to do.
- 60 From the above analysis, it is clear that the Auditor has not given any importance to this important aspect of assessment of recoverability of loans of Rs 3,235.16 crores from VGS & others. She simply obtained some documents and placed them in the Audit File, evidencing that the Audit was performed in a perfunctory manner, and professional skepticism was completely absent here.
- 61 The Auditor should consider, among other things, gaining an understanding of the business purpose of the transactions and examining supporting documents like agreements, contracts, and other transaction-related documents. There is no audit evidence to support a valid business reason for such huge borrowings and lending transactions. As a result, even when there were circumstances warranting increased scrutiny and facts strongly suggesting fraud, the Auditor overlooked the matter and failed to perform any additional auditing procedures. This indicates that the Auditor did not exercise the necessary professional skepticism to determine whether these transactions posed a risk of material misstatement due to fraud.
- 62 In view of above analysis, we find that this charge is proved that the Auditor has violated section 143(3)(e), 143(12) of the Act, CARO, SA 200, SA 240, SA 250, SA 315, SA 330, SA 500 and failed to report violation of section 179(3), 180(1)(c) and 186 of the Act by MACEL.
- C.2 Lapses in audit relating to accounting of related party borrowings and bank borrowings resulting in misstatements by Rs 2,363.34 crore due to fraud**
- 63 The Auditor was charged with failure to perform risk assessment procedure to identify and assess Risk of Material Misstatements due to fraud and failure to exercise professional skepticism while

performing audit of related party balances which were fraudulently understated by another accounting fraud involving issuance of cheques showing repayment of related party loans in FY 2018-19 (March 2019). Such cheques were cleared in FY 2019-20 by evergreening of loans through structured circulation of funds among Coffee Day Group entities. This resulted in her failure to evaluate & report material & pervasive misstatements of Rs 2,363.34 crore in the Financial Statements of MACEL. In March 2019, MACEL had issued cheques worth Rs 2,038.54 crores for repayment of related party loans, without having adequate bank balance (Rs 0.16 crore bank balance on 31.03.2019) and/or without having any approved bank credit limit. These cheques were not cleared on 31.03.2019 and shown in Bank Reconciliation Statements ('BRS' hereafter) as cheques issued but not cleared. Similarly, in March 2019, MACEL received cheques of Rs 324.80 crores from related parties. These cheques were not realised on 31.03.2019 and were shown in BRS as cheques received but not realised. Analysis of cheques issued and received by MACEL in FY 2018-19 but debited and credited in FY 2019-20 indicates structured circular transactions with fraudulent intention of suppressing true balances of borrowings from related parties and presenting a sound financial position. This accounting fraud resulted in understatement of the Related Party Borrowings by Rs. 1,713.74 crores (Rs 2,038.54 crores of cheques issued - Rs 324.80 crores of receipts) and overstatement of Bank Borrowings by Rs 1,713.74 crores in the Balance Sheet.

Table - 4

				Rs In Crores
Sr No	Bank name	Actual bank balance as on 31.03.2019	Sanctioned bank limit	Amount of cheques issued but not cleared till 31.03.2019
1	Karnataka Bank	0.00	No information available	1,175.00
2	Corporation Bank	0.03		773.04
3	Indusind Bank	0.13	No bank limit was sanctioned	25.00
4	Yes Bank	0.00		65.50
	Total	0.16		2,038.54

- 64 It can be observed from Table 4 that MACEL had a nominal bank balance but issued cheques of Rs 2,038.54 crores. Similarly, cheques for Rs 324.80 crores were received in 2018-19 but were not credited in the Corporation Bank account in the same year. These cheques were used to effect a series of circular transactions in 2019-20 aimed at evergreening of loans. As detailed in preceding paragraphs, this resulted in MACEL showing Rs. 1,713.57 crores as 'Credit balance in bank accounts'. By such fraudulent reporting, MACEL had converted related party borrowings into bank borrowings in the Financial Statements resulting in material and pervasive misstatements in the Balance Sheet as it constituted 49.50% of total liabilities of Rs 4,118.18 crores.
- 65 Bank statements show that MACEL was using electronic mode of payment i.e., RTGS (Real Time Gross Settlement) and NEFT (National Electronic Fund Transfer) for making payment for other transactions, whereas cheques were issued for conversion of related party borrowings into bank borrowings. A different manner of making such payments was an additional indicator of fraudulent intent to misstate critical and sensitive information in the Financial Statements. The clearance of large numbers of cheques by circulating significantly lower bank balance, popularly

known as 'Ever Greening of Loans', was an indicator of the severe financial crisis in MACEL and fraudulent intentions of MACEL to misstate the Financial Statements.

- 66 There is no evidence in the Audit File that the Auditor had performed any risk assessment procedures to identify risk of misstatement¹² due to fraudulent conversion of related party borrowings into bank borrowings. This was despite the fact that note no-5 to the Financial Statements clearly depicted a credit balance in bank accounts of Rs 1,713.57 crores with foot note that it represents payments made by the MACEL, which were yet to be cleared by the bank.
- 67 One of the important substantive audit procedures is to examine the Bank Reconciliation Statement. Evergreening of loans through structured circulation of funds shows that the Auditor did not exercise due diligence while performing an audit of BRS.
- 68 The Auditor was required¹³ to perform the audit with Professional Skepticism recognizing the possibility that a material misstatement due to fraud could exist. The unusual feature of issuing the cheques of huge amount in the last month of FY 2018-19 i.e. March 2019 and its clearance in April/May 2019 by getting the funds from same or other related parties and thereafter rotating funds amongst related parties were an indication of fraud. There is no evidence in the Audit File that the Auditor had asked any question to Those Charged With Governance ('TCWG' hereafter) and Management about these unusual transactions. The Auditor was charged with non performing the audit with required level of professional judgement and professional skepticism.
- 69 As per section 143(1) of the Act, the Auditor is also required to inquire whether transactions are represented merely by book entries and are prejudicial to the interest of the company. As explained above, accounting entries for Rs 2,038.54 crores were mere book entries without adequate bank balance and/or bank credit limit. The Auditor did not perform any audit procedure and did not report these apparently fictitious accounting entries and thus violated section 143(1) of the Act.
- 70 Accordingly, the Auditor was charged with non-compliance with SA 200, SA 240, SA 315, section 143(1), 143(12) of the Act and the CARO.

Reply of Auditor

- 71 While denying the charge, the Auditor did not dispute the facts. She replied that uncleared/unrealised cheques on 31-03-2019 were pipeline bank entries and she could not see any wrong intent of the management. Credit balance in bank accounts were properly shown and disclosed in the Financial Statements, conveying correct message that the company has tight financial position. She further replied that she had examined the bank statements of FY 2019-20 with the limited objective of verifying clearance of pipeline bank cheques. She argued that examination of source of funds used for clearance of these cheques was not required for audit of FY 2018-19, therefore she did not do so. The Auditor further argued that allegation of

¹² Please refer para 5 of SA 315.

¹³ Please refer para 15 of SA 200 and para 12 of SA 240.

evergreening of loans and circular transactions, with reference to transactions in FY 2019-20, is baseless in the context of the Audit of FY 2018-19.

- 72 The Auditor claimed that this was a usual practice for the company that it had large amounts of cheques that were outstanding as unpaid and were cleared in the next year. MACEL had similar practice in previous year also. According to her, **eagerness to pay off dues before year end to achieve a cleaner Balance sheet is the motivation for a management to undertake such transactions.** An auditor would not be able to see any fraudulent intent in issuance of such cheques. Further, management had not revealed the reality to the Auditor during audit. Accordingly, to her, no amount of professional skepticism would help the auditor to suspect the management's fraudulent intent over such practice.
- 73 The Auditor has stated that allegation of fraudulent intentions of MACEL for evergreening of loans was based on study of the details of funding in 2019-20 to clear the cheques issued in 2018-19. The process followed in audit is to obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement. While drawing attention to para 10 to 15 of SA 700 relating to the Auditor's responsibility relating to forming audit opinion, she argued that it does not include any mandatory responsibility on an auditor to examine the manner in which funds were managed by the company in the subsequent year to clear the cheques issued in the year under audit. That is not in the scope of a Statutory Auditor, in the normal course of audit. The Auditor further stated that the observations of NFRA are based on findings of the forensic auditors.
- 74 While drawing attention to para 5 of SA 240 regarding inherent limitations of an audit, the Auditor stated that she examined the bank statement of 2019-20 with limited objective of finding out clearance of pipe line bank cheques. The Auditor stated that she did not examine the source of funds used for clearing those cheques and for the audit of 2018-19, it was not necessary for her to conduct a detailed examination of cash/fund flow recorded in the books of accounts of 2019-20.
- 75 While drawing attention to para 13 of SA 240 relating to professional skepticism, the Auditor submitted that she had no reason to believe any wrongful intentions of management (evergreening of loans and circular transactions) while undertaking the audit of 2018-19.
- 76 The Auditor replied that disclosure of Related Party Transactions ('RPT' hereafter) was in compliance with AS 18. She argued that 'credit balance in bank accounts' represented by uncleared cheques, is not the same as bank borrowing. It is just a book balance. According to her, allegation of conversion of related party liabilities into bank liabilities has no merit and there is no material misstatement in the Financial Statements. She argued that she had not found any fraud from these transactions therefore there was no case for reporting u/s 143(12) of the Act.
- 77 With reference to use of traditional method of cheques payment at year end for payment of related party loans as against the normal method of electronic payment, the Auditor argued that alternative mode of cheque payment was proper cash flow planning in the background that the company faced liquidity crisis. She referred to para A4 of SA 240 and mentioned that these transactions do not fall in the scope of "*recording fictitious journal entries, particularly close to*

the end of an accounting period, to manipulate operating results or achieve other objectives” or “complex transactions that are structured to misrepresent the financial position or financial performance of the entity” or “concealing or not disclosing facts that could affect the amounts recorded in the financial statements”.

- 78 The Auditor submitted that she had examined the elements in the Financial Statements for accuracy of amounts, correctness of time of recognition, completeness of transactions with associated documents, classification, presentation and disclosures in FS through a detailed process achieved through on ground actions in an exercise involving verification, validation, examination, discussion and inspection etc. The Auditor claimed that it is not humanly possible to record the whole of the process adopted by an auditor in her working papers, nor is there any such requirement in SA 230, Audit Documentation. However, the Auditor had documented the procedure followed in her own way for compliance of SA 230 and SA 315. The process of examination by the Auditor did not result in identification of risk of any material misstatement.
- 79 The Auditor further stated that there is no provision in law to hold an auditor guilty for professional misconduct because she has erred in her judgment in the application of provisions in SA 240 or SA 200. Standards of Auditing are not reference material to decide on charges of professional misconduct against an auditor; on the contrary they are guidance to an auditor to act professionally.
- 80 While denying the charges relating to violation of section 143 (1) of the act, the Auditor submitted that cheque entries do not qualify as journal entries, these were actual bank transactions. Therefore, these were not fictitious accounting entries.

Analysis of reply

- 81 It is an undisputed fact that in March 2019, MACEL had issued cheques of huge amount totalling Rs 2,038.54 crore towards repayment of related party borrowings without having sufficient bank balance and without having any approved credit limits in bank accounts. It is also a fact that MACEL received cheques worth Rs 324.80 crore from related parties and that these cheques were cleared in the next financial year i.e., FY 2019-20 by circulating funds among related parties. MACEL had outstanding loan of Rs 2893.25 crores on 31.03.2019 payable to seven largest related parties, out of which six parties were subsidiary companies of CDEL. On 30/31.03.2019, it had issued cheques of Rs 1,879.17 crores in favour of these companies and brought down the outstanding loan from Rs 2,893.25 crores to Rs 1,014.08 crores. This is depicted in Table-5 hereunder:

Table-5 Rs in crores

Loans from seven largest Related Parties taken by MACEL				
Sr No	Name of company from whom funds were borrowed.	Balance as on 31.03.2019 as per FS	Balance reduced Fraudulently*	Total outstanding as on 31.03.2019
(1)	(2)	(3)	(4)	(5=3+4)
1	Tanglin Retail Realty Development Pvt Ltd	789.35	685.01*	1,474.36

2	Coffee Day Global Ltd	64.82	222.50	287.32
3	Tanglin Development Ltd	-11.68	474.00	462.32
4	Coffee Day Trading Ltd	0	125.00	125.00
5	Coffee Day Hotels & Resorts Pvt Ltd	0	150.00	150.00
6	Giri Vidhyut (India) Ltd	0	50.00	50.00
7	Gonibedu Coffee Estate Pvt Ltd	171.59	172.66	344.25
	Total	1,014.08	1,879.17	2,893.25

Note-* Gross amount of cheques issued in FY 2018-19 to TRRDPL was Rs 826 crores, which was cleared in FY 2019-20. MACEL had also received cheques of Rs 140.99 crores from TRRDPL in FY 2018-19, which were realised in FY 2019-20. Therefore, net amount has been shown.

82 These cheques were cleared/realised in FY 2019-20 by evergreening of loans through structured circulation of funds. One example of such circulation of funds for clearance of cheques of Rs 1,175 crores (relating to Karnataka Bank account) is given here. MACEL's bank a/c no xxxxxxxx at Karnataka Bank had credit balance of Rs 43,790.92 only as on 31.03.2019, and there was no sanctioned bank credit limit for this bank account. However, eleven cheques for total amount of Rs 125.00 crores were issued favoring CDGL, four cheques of total amount of Rs 350 crores were issued to TDL, eight cheques of total amount of Rs 650 crores were issued to TRRDPL, and five cheques of total amount of Rs 50 crores were issued to GVIL. On the basis of the cheques issued, the outstanding loans taken from these related parties (including subsidiaries of CDEL-a listed company) were reduced by Rs 1,175 crores in the Financial Statements for FY 2018-19. These subsidiaries of CDEL also adopted similar accounting jugglery in their respective financial statements for FY 2018-19 and reduced the loans given to promoter owned MACEL by same amount on the basis of the cheques received from MACEL. In the next financial year i.e., 2019-20, these cheques were cleared in a series of circular transactions among related parties. Such as: On 10.04.2019, MACEL received Rs 90 crores from CDGL which started a series of sham payments on the same day in a circular manner for clearance of four cheques of Rs 350 crores issued to TDL on 31.03.2019 & eight cheques of Rs 650 crores issued to TRRDPL on 30.03.2019. For example, Rs 90 crores received from CDGL was paid by MACEL to TDL, which then paid Rs 90 crores to GVIL, which then paid Rs 90 crores to MACEL, which then paid Rs 50 crores to GVIL, which then paid Rs 50 crores to MACEL, which then paid Rs 90 crores to TDL, which then paid Rs 90 crores to GVIL, which then paid Rs 90 crores to MACEL, which then paid Rs 90 crores to TDL, which then paid Rs 90 crores to GVIL, which then paid Rs 90 to MACEL, which then paid Rs 90 crores to TRRDPL, thereafter Rs 90 crores was paid by TDL to MACEL, which then paid Rs 80 crores to TDL, and so on.....

83 Similar instances were also noticed in the following bank accounts:

- Bank a/c no xxxxxxxx at Corporation Bank had credit balance of Rs 3,45,603.74 only on 31.03.2019. There was no sanctioned bank credit limit for this bank account. MACEL issued several cheques of total amount of Rs 773.04 crores to various entities, which were cleared through a series of circular transactions among group companies in the 2019-20.
- Bank a/c no xxxxxxxx with IndusInd Bank had a balance of Rs 13,13,699.00 on 31.03.2019. There was no sanctioned bank credit limit for this account. MACEL had issued

five cheques of total amount of Rs 25.00 crores on 30.03.2019 to CDGL. On 02.04.2019, it received Rs 32 crores from CDGL through six RTGS transactions, which were then used to clear on the same day, one by one in circular manner, the five cheques issued on 30.03.2019.

- Bank a/c no xxxxxxxxx with Yes Bank had nil balance on 31.03.2019. There was no sanctioned bank credit limit for this account. On 04.04.2019, MACEL received credit of Rs 30 crores (from related parties including CDGL), thereafter, this fund was used on the same day for clearance of three cheques valuing Rs 65.50 crores issued to CDGL on 30.03.2019. These bank transactions were done one by one in a circular manner by circulating funds between MACEL and CDGL in smaller amounts on the same day.

84 It can be observed from the bank statements, that all the cheques of Rs 2,363.34 crores were cleared in the same fraudulent manner by circulating smaller amount to create transactions of larger amount. There is no doubt that promoters of MACEL had pre-meditated plan to misrepresent liabilities in the Financial Statements of MACEL and subsidiaries of listed company for FY 2018-19 by issuing cheques before year end which would only be cleared in next financial year by evergreening of related party loans through structured circulation of funds in April/May 2019. From the above analysis, it is crystal clear that this accounting fraud was orchestrated to conceal the fact that funds belonging to the listed company (CDEL) have been diverted to a promoter owned entity i.e., MACEL.

85 The reply of the Auditor is silent as to her analysis and evaluation of MACEL issuing these cheques without having adequate bank balance and bank credit limit. Cheques of Rs 2,038.54 crores issued but not cleared on 31-03-2019 represented 49.5% of the total balance sheet size of MACEL. These cheques were issued for repayment of related party loans. The accounting effect of these pipeline entries was that related party loans were reduced and bank liabilities were increased in the balance sheet as on 31-03-2019. Therefore, in our view, the Financial Statements of MACEL conveyed a false message that MACEL's loan liabilities from related parties were less by Rs 2,038.54 crores and liability towards bank was higher by the same amount, thus the Balance Sheet did not give true and fair view of its state of affairs, which the Auditor failed to report in her Audit Report.

86 Further, the Auditor has claimed that during the audit of 2018-19, she had verified bank statement of 2019-20 to verify clearance of cheques issued/received in 2018-19 but not cleared/received as on 31-03-2019. According to her, verifying the source of funds for clearance of these cheques was not required for the Audit of 2018-19. For analysis of this reply, we show in Table 6 an excerpt of the bank statement of MACEL on 10-04-2019:

Table-6 (Rs in crores)

Transaction Date	Instrument Number	Transaction particulars	Withdrawals	Deposits	Balance
10-04-2019		CDGL		85.00	85.02
10-04-2019		CDGL		5.00	90.02
10-04-2019	467643	TDL	90.00		0.02
10-04-2019		GVIL		90.00	90.02
10-04-2019	467653	GVIL	50.00		40.02
10-04-2019		GVIL		50.00	90.02
10-04-2019	467641	TDL	90.00		0.02

10-04-2019		GVIL		90.00	90.02
10-04-2019	467642	TDL	90.00		0.02
10-04-2019		GVIL		90.00	90.02
10-04-2019	467645	TRRDPL	90.00		0.02
10-04-2019		TDL		90.00	90.02
10-04-2019	467644	TDL	80.00		10.02
10-04-2019		GVIL		80.00	90.02
10-04-2019	467646	TRRDPL	90.00		0.02
10-04-2019		TRRDPL		90.00	90.02
10-04-2019	467647	TRRDPL	90.00		0.02
10-04-2019		TRRDPL		90.00	90.02
10-04-2019	467648	TRRDPL	90.00		0.02
10-04-2019		TRRDPL		90.00	90.02
10-04-2019	467650	TRRDPL	90.00		0.02
10-04-2019		TRRDPL		90.00	90.02
10-04-2019	467654	TRRDPL	20.00		70.02
10-04-2019		TRRDPL		20.00	90.02
10-04-2019	467651	TRRDPL	90.00		0.02
10-04-2019		TRRDPL		90.00	90.02
10-04-2019	467649	TRRDPL	90.00		0.02
10-04-2019		TRRDPL		90.00	90.02

Note: Two changes have been made for brevity in bank statement. The amount has been rounded off to Rs in crores and only abbreviation is used for the party's name.

- 87** It is surprising that the Auditor while looking at debit entries (withdrawal) in this bank statement for verification of cheques issued but not cleared, did not look at the source of funds i.e., credit entries (deposits) on the same page of the bank statement. This argument is not logical. The Auditor is required to perform an audit with professional skepticism (SA 200). Evergreening of loans through structured circulation of funds was clearly visible from the above bank statements. The Auditor was required to evaluate this evident evergreening of loans while verifying clearance of cheques issued in 2018-19. It is clear that the Auditor has failed to exercise professional skepticism while verifying bank statements. Therefore, we are of the view that the Auditor's inert passivity in the face of known and visible evergreening of loans & understatement of related party borrowings does not insulate her from her gross failure in the performance of Audit.
- 88** Para 10 to 15 of SA 700 - 'Forming an Opinion and Reporting on Financial Statements', provides that in order to form an audit opinion, the Auditor is required to conclude whether she has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatements whether due to fraud or error. Evergreening of loans through circulation of funds was visible from bank statements, which are claimed to have been verified by the Auditor. However, she failed to consider the same while forming the audit opinion. Accordingly, we find that the Auditor was grossly negligent in making conclusions and forming an audit opinion.
- 89** The Auditor's plea that the use of traditional method of issuance of cheques for circulation of funds to group entities as against the electronic payment system adopted for other business transactions, was done to maintain proper cash flow, cannot be accepted. Especially when we see that a large number of such cheques are issued at the end of the financial year with insufficient

balance in the bank accounts. The Auditor herself has relied on para A4 of SA 240 in her reply, which deals with instances of fraudulent financial reporting and techniques used for the same. Quoting two items from para A4 of SA 240 would clearly establish how MACEL's case clearly falls in the ambit of fraudulent reporting.

“Engaging in complex transactions that are structured to misrepresent the financial position or financial performance of the entity”.

“Concealing or not disclosing facts that could affect the amounts recorded in the financial statements”.

- 90 The Auditor, in her reply to not recognising the apparent fraud has drawn attention to para 13 of SA 240 providing that *“unless the auditor has reason to believe the contrary, the auditor may accept records and documents genuine”*. It is surprising how the Auditor did not see the contents of the preceding para 12 of SA 240, which provides that *“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 Auditor evidently did not exercise professional skepticism while performing audit of bank transactions and relied on her wrong impression that promoters were honest and had good reputation.
- 91 The admission by the Auditor that her process of examination did not result in identification of RoMM, is a proof that her process of examination of RoMM lacked depth and professional skepticism so as to completely overlook an obvious, visible evergreening of loans through circulation of funds from the bank statements of MACEL.
- 92 We are surprised to note that as per the Auditor's judgement that issuance of cheques for such large amounts at the end of the year was a regular practice of the management to achieve a clearer Balance Sheet and that she saw no intent of fraud in the same. This also indicates that the Auditor was aware of this modus of understatement of loans at year end and evergreening of loans in subsequent year but did not consider it a misstatement in the Financial Statements of MACEL. Despite being privy to this accounting fraud, she did not report this to the Central Government and has tried to justify its motive. Such a view of the Auditor implies her acquittal of a ruse and a colourable devise used by the company for fraud. We find that the Auditor failed in discharge of her statutory duty in performance of the statutory audit of MACEL for FY 2018-19.
- 93 In respect of contention of the Auditor that SAs are not reference material for deciding misconduct of an auditor, we notice that auditor is duty bound to comply with SAs in terms of section 143(9) & 143(10) of the Act¹⁴. Further, ICAI in its Implementation Guide on Reporting Standards issued in Nov 2010, had opined in response to question no-12 relating to the Auditor's responsibility paragraph that *“A key assertion that is made in this paragraph is that the audit was conducted in accordance with the SAs. SA 200¹⁵, which in a way is the “parent standard” on auditing, prohibits the auditor from representing compliance with SAs in the auditor's report*

¹⁴ Section 143(9) of the Act provides that every auditor shall comply with the auditing standard. Further proviso to section 143(10) of the Act provides that until any auditing standards are notified, any standard or standards of auditing specified by the Institute of Chartered Accountants of India shall be deemed to be the auditing standards.

¹⁵ SA 200, Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing

unless the auditor has complied with the requirements of this SA and all other SAs relevant to the audit. This is a very broad and onerous assertion for an auditor to make. If during a subsequent review of the audit process, it is found that some of the audit procedures detailed in the SAs were not in fact complied with, it may tantamount to the auditor making a deliberately false declaration in his report and the consequences for the auditor could be very serious indeed". In this case, the Auditor in its Independent Auditor's Report dated 05.06.2019 has inter alia asserted that "***We conducted our audit in accordance with the Standards on Auditing specified under section 143(10) of the Act***". Thus, there is no scope for deviation from the SAs, the fundamental principles of which are contained in their Requirements section and are represented by use of "**shall**". Further, section 143(9) of the Act also states that "Every auditor **shall** comply with the auditing standards". (Emphasis supplied).

- 94 Regarding non-adherence with section 143(1)(b) of the Act with reference to structured circulation of funds, we note that this was intentionally done by MACEL to misstate the Financial Statements as it did not result in net cash flow and remained only book entries, therefore resulting in fictitious accounting entries as per section 143(1)(b) of the Act.
- 95 We observe that the Auditor has not given any reply in respect of the charge relating to failure to exercise due diligence during audit of Bank Reconciliation Statement ('BRS' hereafter), which has many deficiencies like realisation of Rs 164.58 crores appearing in BRS but not found in bank statements, discrepancy in cheque number between BRS and bank statements, cheques bearing dates of FY 2019-20 were accounted for in FY 2018-19, same cheque number used for multiple payments of different amounts, same cheque number has different dates at different places and difference between instrument date & bank date was more than validity period of cheques. The Auditor is silent on these discrepancies.
- 96 The above analysis indicates that the Auditor did not exercise the necessary professional skepticism to determine whether these transactions posed a risk of material misstatement due to fraud. She failed to obtain sufficient and appropriate audit evidence in respect of these circular transactions. In view of the above analysis, we find that this charge is proved that the Auditor had violated section 143(1)(b) & 143(12) of the Act, CARO, SA 200, SA 240 and SA 315.

C.3 Lapses in audit of inappropriate recognition of finance cost of Rs 55.38 crores

- 97 The Auditor was charged with failure to perform risk assessment procedure & analytical procedure and failure to exercise professional skepticism in respect of inappropriate recognition of finance cost of Rs 55.38 crores as corresponding borrowings were not used for business activity of MACEL. The Auditor was also charged with violation of section 143(2) & 143(3)(e) of the Act, as finance cost was an extraordinary expense but was shown as ordinary finance cost resulting in violation of Division I of Schedule III of the Act and Accounting Standards 5¹⁶.
- 98 MACEL has recognized finance cost of Rs 55.38 crores in FY 2018-19, which constituted 90.89% of total expenses of Rs 60.93 crores. Total bank borrowing of the company was Rs 405.64 crores on 01-04-2018 and Rs 272.32 crores on 31.03.2019. Borrowed money was not

¹⁶ AS 5, Net Profit or Loss for the period, Prior Period Items and Changes in Accounting Policies.

used for the business activity of the company but diverted to related parties. Out of the total assets of Rs 3,894.53 crores, 99% were loans & advances given worth Rs 3,858.51 crores, leaving assets of only Rs 36.02 crores to be used for business activities of MACEL. Though the finance cost of borrowed fund was recognized, the corresponding interest income on loans and advances given to promoters and other related parties was not realized, resulting in material and pervasive misstatement in the Profit and Loss Statement by a large proportion of finance cost.

- 99 As per para 5 of SA 315, the Auditor was required to perform risk assessment procedures to provide a basis for the identification and assessment of RoMM in respect of finance cost. Para 6 of SA 520, Analytical Procedures, required the Auditor to design and perform analytical procedures near the end of the audit that would have assisted her when forming an overall conclusion as to whether the financial statements are consistent with her understanding of MACEL. As a prudent audit procedure, she was required to critically analyze the finance cost & bank borrowings with the assets used for business activity of MACEL. Professional Skepticism should have aroused suspicion in her mind that something was amiss. As per para 32(c) of SA 240, she was required to evaluate whether there was any fraud in recognition of finance cost (being unusual in nature). Examination of Audit File shows that she did not perform any audit procedure or question the TCWG and Management about the same, and was therefore charged to have violated SA 200, SA 240, SA 315 & SA 520.
- 100 Further, as per para 4.2 of AS 5, Extraordinary items are income or expenses that arise from events or transactions that are clearly distinct from the ordinary activities of the enterprise and, therefore, are not expected to recur frequently or regularly. Finance cost was not for ordinary activity of MACEL, hence was required to be treated as extraordinary item, if at all it was justifiable. As per Division I of Schedule III of the Act and para 8 of AS 5, extraordinary items should be disclosed on the face of the Profit and Loss Statement. The nature and the amount of each extraordinary item should be separately disclosed in the Profit and Loss Statement in a manner that its impact on current profit or loss can be perceived. Accordingly, MACEL was required to disclose the finance cost as extraordinary expense in the Profit and Loss Statement in the manner described above. Examination of the Financial Statements shows that MACEL did not disclose finance cost as extraordinary expense but disclosed it as ordinary finance cost, thus violating Division I of Schedule III of the Act and AS 5. Section 143(3)(e) of the Act requires an auditor to state in the auditor's report whether the Financial Statements comply with the Accounting Standards. It was reported in the Audit report that the Financial Statements comply with the Accounting Standards specified under section 133 of the Act, read with Rule 7 of the Companies (Accounts) Rules, 2014. The Auditor was therefore charged to have violated section 143(2) & 143(3)(e) of the Act.

Reply of Auditor

- 101 While denying the charge, the Auditor has stated that she had no role to play in deciding whether advances granted by the company would earn interest or not. MACEL was required to pay interest on money borrowed whereas in respect of advances made by MACEL, there was no contractual obligation on the borrowing entities to pay interest. Therefore, interest expenses

accounted for was not in violation of any law nor was it inconsistent with accounting principles in force. According to her, there was no misstatement.

- 102** The Auditor has further argued that the directors had appropriate powers to enter into those transactions. The Auditor has no authority to challenge the transactions undertaken by the directors, without having appropriate evidence to challenge them. According to the Auditor, NFRA's view is unjustified, as it is based on the events occurred and information emerged, after the audit was completed by the Auditor. The Auditor further replied that she had reported in the CARO report that advances made by the company were interest free. Therefore, she had no further reporting obligation.
- 103** While referring to para 9 & 10 of AS 5, the Auditor replied that going by the spirit of the principles in AS 5, the finance cost was not an extra-ordinary item, accordingly there is no violation of section 143(2) and 143(3)(e) of the Act.

Analysis of reply

- 104** MACEL is a small company having Revenue from Operation of Rs 1.71 crores only. Its total business assets were Rs 36.01 crores only in the form of Tangible assets, Inventories, Cash and Cash equivalent and Other Current Assets. Whereas its Balance Sheet size was Rs 3,894.53 crores mainly on account of Rs 3,858.51 crores loans given to related parties, with whom MACEL did not have any business relations. Therefore, the loans given to the related parties were beyond the normal course of business.
- 105** MACEL's total borrowings were Rs 4,112.47 crores, of which a major part was from related parties. Since the assets used for the business activities of MACEL amounted to only Rs 36.01 crores, remaining borrowings of Rs 4,076.46 crores (Rs 4112.47 crores - Rs 36.01 crores) were diverted to related parties without any business rationale. Therefore, diversion of funds was clearly visible from the Balance Sheet signed by the Auditor.
- 106** MACEL recognised huge interest expenses of Rs 55.38 crores, whereas interest income of Rs 2.34 crores only was recognised in its Profit and Loss Statement signed by the Auditor. A combined reading of the Balance Sheet and the Profit and Loss Statement clearly shows that proceeds of interest-bearing borrowings were diverted to related parties at no or nominal interest. Therefore, it is clear that Related Party Transactions were not at 'Arm's Length' basis and were prejudicial to the interest of the company. Further, this has resulted in recognition of loss of Rs 56.89 crores in the Profit & Loss Statement for FY 2018-19. Had the interest been recovered from the related parties, which used these funds, loss of MACEL would have been of a minuscule amount. Similar trend is visible in FY 2017-18. This practice has eroded the entire net worth of the company, bringing it down to a negative Rs 223.65 crores in the Balance Sheet on 31.03.2019.
- 107** The Auditor has replied that interest expense was incurred and duly accounted for. She could not give any reply as to why such interest expense should be ultimately borne by MACEL, when the borrowed money was not used by MACEL, but lent out to related parties mostly at zero interest. In fact, interest expenses should have been at least recovered from those entities which had ultimately used the funds borrowed by MACEL, which was not done. In that context, we find

that interest expense of Rs 55.38 crores has resulted in misstatement in the Profit and Loss Statement of MACEL.

- 108** Diversion of interest-bearing loan proceeds to promoters/their entity without any interest was a proof of fraudulent intention of promoters to recognize loss in the Profit and Loss Statement of MACEL and therefore it was an unusual transaction. The Auditor was duty bound as per SA 240 to evaluate such unusual transaction, which she failed to do. Further, disclosure given in CARO report relating to interest free nature of advances made, does not absolve the Auditor from her responsibility to report misstatement in the Profit and Loss Statement, which is required to be reported in the Independent Auditor's Report as per SA 700.
- 109** Para 9 of AS 5 states "*Virtually all items of income and expense included in the determination of net profit or loss for the period arise in the course of the ordinary activities of the enterprise. Therefore, only on rare occasions does an event or transaction give rise to an extraordinary item*". Further para 10 of AS 5 provides that nature of transaction determines whether a transaction is distinct from ordinary activity of the enterprise. In this case interest expense did not arise in the course of ordinary activity of MACEL but due to borrowing meant to siphon off funds by the promoters, therefore this is a rare occasion and such interest expense was to be classified as extraordinary expense.
- 110** Division I of Schedule III of the Act prescribes the format of the Profit and Loss Statement, which has been followed by MACEL. This format includes one line item 'Extraordinary Items'. MACEL has shown NIL amount against this line item. MACEL did not classify interest cost of Rs 55.38 crores as extraordinary item in the Profit and Loss Statement, thus violated Division I of Schedule III of the Act and AS 5. The Auditor did not report this violation in her Audit Report. In view of above analysis, we find that the Auditor has violated section 143(2) and 143(3)(e) of the Act.

C.4 Lapses in audit relating to misstatement of Rs 909.99 crores in Cash Flow Statement

- 111** The Auditor was charged with failure to report material misstatement of Rs 909.99 crores in Cash Flow Statement resulting in violation of section 143(2) and section 143(3)(e) of the Act. MACEL failed to comply with AS 3, Cash Flow Statements, which provides that short term borrowings are to be disclosed as Cash Flow from Financing Activities. However, MACEL has recognized increase in short term borrowings of Rs 850.90 crores as Cash Flow from Operating Activities resulting in overstatement of Cash Flow from Operating Activities and understatement of Cash Flow from Financing Activities by Rs 850.90 crores. Further, as per AS 3, Loans and advances made to third parties are to be disclosed as Cash Flow from Investing activity (other than advances and loans made by financial enterprise). MACEL did not consider itself a financial enterprise. However, MACEL has disclosed increase in short term loans & advances made (assets) of Rs 59.09 crores as Cash Flow from Operating Activity (as negative figure) resulting in understatement of Cash Flow from Operating Activity and overstatement of Cash Flow from Investing activity by Rs 59.09 crores.

Reply of Auditor

- 112** The Auditor has partially admitted the charge relating to wrong presentation of cash flow from short-term borrowing in Cash Flow from Operating Activities. According to her, out of Rs 850.90 crores, Rs 68 crores represented borrowings and deserved to be included under ‘Cash Flow from Financing Activities’ and remaining amount represented changes to operating assets/liabilities like advances received and advances given, and therefore correctly classified under ‘Cash Flow from Operating Activities’. The Auditor further stated that the admitted mistake may be pardoned as an inadvertent presentation error.
- 113** In respect of charge relating to loans/advances made to third parties, the Auditor denied the charge stating that advances were given for furtherance of their business objectives associated with several coffee estates managed by associate entities and accordingly these advances were related to operations. She further contended that they were not loans. The Auditor stated that the term ‘Advance’ and ‘Loan’ are interchangeably used in AS 3, which is misleading and accepted that loans given would certainly be ‘Cash Flow from Investments’. She further contended that there is always room for following an alternate accounting policy by virtue of the provisions in para 12 to 17 of AS 1, Disclosure of Accounting Policies, and Section 129(5) of the Act. The Auditor finally stated that according to the substance of the advance transactions, it was proper to present them as Cash Flow from Operating Activities.

Analysis of Reply

- 114** Para 3 and 4 of AS 3 describe the importance of Cash Flow Information as *“A cash flow statement, when used in conjunction with the other financial statements, provides information that enables users to evaluate the changes in net assets of an enterprise, its financial structure (including its liquidity and solvency) and its ability to affect the amounts and timing of cash flows in order to adapt to changing circumstances and opportunities. Cash flow information is useful in assessing the ability of the enterprise to generate cash and cash equivalents and enables users to develop models to assess and compare the present value of the future cash flows of different enterprises. It also enhances the comparability of the reporting of operating performance by different enterprises because it eliminates the effects of using different accounting treatments for the same transactions and events. Historical cash flow information is often used as an indicator of the amount, timing and certainty of future cash flows. It is also useful in checking the accuracy of past assessments of future cash flows and in examining the relationship between profitability and net cash flow and the impact of changing prices”*.
- 115** Para 8 of AS 3 provides that the cash flow statement should report cash flows during the period classified by operating, investing and financing activities, which are defined as under:
- a) Operating activities are the principal revenue-producing activities of the enterprise and other activities that are not investing or financing activities.
 - b) Investing activities are the acquisition and disposal of long-term assets and other investments not included in cash equivalents.

- c) Financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in the case of a company) and borrowings of the enterprise.

- 116** Therefore, the importance of Cash Flow information and its classification are clearly prescribed in AS 3, which were to be complied by MACEL. In her reply, the Auditor has admitted wrong presentation of cash flow from short-term borrowing of Rs 68 crores in 'Cash Flow from Operating Activities' in place of 'Cash Flow from Financing Activities'. Accounting and analysis of Cash Flow is an important aspect of Auditing. The reply of the Auditor asking it to be treated as an inadvertent error in presentation, smacks of her casual approach.
- 117** For the remaining borrowings of Rs 782.90 crores (Rs 850.90 crores-Rs 68 crores), the Auditor has contended that these represented changes to operating assets/liabilities like advances received and advances given, and therefore correctly classified under 'Cash Flow from Operating Activities. In fact, these were borrowings, and these qualify as Cash Flow from Financing Activities, as per the definition quoted above. It was further seen that these borrowed funds of Rs 782.90 crores were not used for principal revenue-producing activities of MACEL, but used for fraudulent diversion of funds to the entities, with whom MACEL did not have any operational/business relations. This Cash Flow was on account of short-term borrowings, therefore required to be classified as Cash Flow from Financing activities as required in AS 3.
- 118** Similarly, in respect of Cash Outgo on account of loans/advances of Rs 59.09 crores made to related parties, it is observed that these were not included in cash equivalent, therefore these were Investment Activities as per its definition quoted above. MACEL did not have any operational/business relations with other coffee estates managed by associate entities; thus this amount was not used for main revenue-producing business activities of MACEL.
- 119** Further, as per normal business practice an 'Advance' is given to a supplier of goods or service as a part payment, to be adjusted at the time of final settlement or excess amount, if any, to be refunded at the time of final settlement after delivery of goods or service. Whereas 'Loan' is money given by one person to another with a clear understanding that the recipient of the money will return the money to the lender after a certain period of time normally with interest. In this case, money given by MACEL to other entities was not for supply of any goods or services to MACEL, therefore such Cash Out Flow cannot be treated as Advance given for principal revenue-producing activities of MACEL. Accordingly, this Cash Flow of Rs 59.09 crores does not qualify as Cash Flow from Operating Activities of MACEL.
- 120** Para 12 to 17 of AS 1 relate to nature of accounting policies, availability of alternative accounting principles, methods of applying those principles, areas in which differing accounting policies are encountered and considerations in the selection of accounting policies like Prudence, Substance Over Form and Materiality. There is nothing in AS 1 which allows an entity to treat borrowing/investing transactions as operating transactions. Further, para 17 of AS 1 state, '*The accounting treatment and presentation in financial statements of transactions and events should be governed by their substance and not merely by the legal form*'. In this case money given by MACEL to related entities was not for supply of any goods or services to MACEL, therefore

keeping in view the substance of transactions in accordance with para 17 of AS 1, such transactions were to be classified as 'Cash Flow from Investing Activities', as defined in AS 3.

- 121** It is clear the MACEL did not comply with AS 3. Section 129(5) of the Act provides that *"Without prejudice to sub-section (1), where the financial statements of a company do not comply with the accounting standards referred to in sub-section (1), the company shall disclose in its financial statements, the deviation from the accounting standards, the reasons for such deviation and the financial effects, if any, arising out of such deviation"*. MACEL did not disclose non-compliance with AS 3 in its Financial Statements, and thus violated section 129(5) of the Act. The Auditor did not report this non-compliance in her Audit Report.
- 122** Therefore, we find that the reply is not satisfactory and this charge stands proved that the Auditor violated section 143(2) and 143(3)(e) of the Act.

C.5 Lapses in evaluation of corporate guarantee and creation of charge on the assets of the company (Rs 130 crores)

- 123** The Auditor was charged with failure to evaluate appropriateness of contingent liabilities of Rs 130 crores created due to the fact that MACEL gave corporate guarantees and created charges on the assets of the company in respect of loan of Rs 5 crores taken by Mrs. Malvika Hegde (wife of VGS-Chairman of CDEL) and borrowing of Rs 125 crores in respect of Non-Convertible Debentures issued by Devadarshini Info Technologies Private Limited, in which VGS was major shareholder. There is no evidence in the Audit File regarding the Auditor's evaluation whether or not these were prejudicial to the interest of the company or its members.
- 124** Further, these transactions and balances were required to be disclosed in the Financial Statements as per para 23 and 24 of AS 18, Related Party Disclosures. MACEL did not make such disclosures in Note no.16 on Related Party Disclosures in the Financial Statements and thus violated AS 18. The Auditor did not report this violation, and was therefore charged to have violated section 143(2) and 143(3)(e) of the Act.

Reply of the Auditor

- 125** While admitting that Audit File does not contain anything regarding evaluation of whether guarantees given were against the interest of the company, the Auditor stated that there is no obligation on the Auditor to evaluate the guarantees from that angle as per clause (iii) and (iv) of the CARO. According to her, this was at worst an error of judgement. This along with non-inclusion of transactions in related party disclosures were admitted by her and she requested to be pardoned.

Analysis of reply

- 126** Issuance of corporate guarantee and creation of charge in respect of loan taken by relatives of promoters and a company in which promoters had major shareholding was an unusual activity as these related parties did not have any business relations with MACEL. It indicates that MACEL shouldered significant financial risk without any business purpose. There was no

necessity for MACEL to take such financial risk. The Auditor did not evaluate whether these were not prejudicial to the interest of the company and she has now contended that there was no such obligation on her to evaluate whether issuance of corporate guarantee and creation of charge was not prejudicial to the interest of MACEL.

- 127** Section 143(2) of the Act casts reporting obligation on the statutory auditor, which includes, inter alia, to *“make a report to the members of the company on the accounts examined by him and on every financial statements which are required by or under this Act to be laid before the company in general meeting and the report shall after taking into account the provisions of this Act, the accounting and auditing standards and matters which are required to be included in the audit report under the provisions of this Act or any rules made thereunder or under any order made under sub-section (11) and to the best of his information and knowledge, the said 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 and such other matters as may be prescribed.”*
- 128** We observe that The Company’s (Audit Report) Order 2016 is an order issued under section 143(11) of the Act. Therefore, CARO is only one of the criteria for consideration while making an audit report, besides Provisions of the Act, Rules made thereunder and provisions of Accounting Standards & Auditing Standards, to decide about truthfulness and fairness of the Financial Statements. Accordingly, before making a conclusion, the Auditor was duty bound to evaluate whether issuance of these corporate guarantees by MACEL and creation of charges on the assets of MACEL, were not prejudicial to the interest of the company, which she failed to do.
- 129** Further, non-disclosure of corporate guarantee of Rs 130 crores in ‘Related Party Disclosures’ was a material misstatement in the financial statements. The Auditor was required to modify her audit report in case of material misstatements in the Financial Statements, which she failed to do.
- 130** In view of the above analysis, we find that this charge is proved that the Auditor violated section 143(2) and 143(3)(e) of the Act.

C.6 Lapses in making audit conclusions and forming audit opinion (consolidated misstatements of point no (C.1) to (C.5) above, Rs 11,393.69 crores)

- 131** The Auditor was charged that she did not consider material misstatements of Rs 11,393.69 crores [loans & advances (liabilities)-Rs 4076.46 crores, loans & advances (assets)- Rs 3,858.52 crores, fraudulent conversion of related party borrowings into bank borrowings Rs 2,363.34 crores, incorrect recognition of finance cost-Rs 55.38 crores, overstatement of cash flow from operating activities- Rs 909.99 crores and issuance of corporate guarantee and creation of charge on the assets of the company-Rs 130 crores without any rationale], while making audit conclusions and forming audit opinion, and thus violated SA 700, Forming an Opinion and Reporting on Financial Statements, which required the Auditor to conclude as to whether the Auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatements, whether due to fraud or error.

- 132** In order to arrive at the audit conclusion, the Auditor is also required to determine materiality for the financial statements as a whole in accordance with SA 320, Materiality in Planning and Performing an Audit. However, examination of the Audit File revealed that she did not determine materiality. She did not perform this basic audit procedure for forming the audit opinion.
- 133** Misstatements in Financial Statements not only represented substantial proportion of the Financial Statements but also affected all components of the financial statements, and accordingly had a pervasive effect on the Financial Statements in terms of para 5(a) of SA 705, Modifications to the Opinion in the Independent Auditor's Report. These misstatements and the evergreening of loans prove that Financial Statements did not give true and fair view of the state of affairs of MACEL. Further, reporting of fraudulent diversion of funds was fundamental to the understanding of users of the Financial Statements. The Auditor had given unmodified audit opinion and did not consider the misstatements of Rs 11,393.69 crores and evergreening of loans while making audit conclusion and forming the Audit Opinion. Accordingly, the SCN charged the Auditor with violation of SA 320 & SA 700.

Reply of Auditor

- 134** The Auditor has denied the charge and stated that the amounts shown as misstatement in SCN do not meet the criterion of misstatements as defined in para 4(a) of SA 450¹⁷. According to the Auditor, to identify misstatements, it is necessary to compare the reported figure and the figure that should have been reported with respect to each element of misstatements, be it in amounts wrongly recognized, wrongly measured, wrongly classified or wrongly disclosed in the Financial Statements. She contended that SCN has not determined misstatements in this manner, therefore determination of misstatements is flawed.
- 135** The Auditor further replied that there is no error in amounts, presentation, classification and disclosures in respect of assets, liabilities and interest cost. While responding to charge relating to misstatement in cash flow statement, she admitted a misstatement of Rs 68 crores. In respect of the misstatement of Rs 130 crores relating to non-funded related party transactions, the Auditor admitted that this matter inadvertently escaped disclosure.
- 136** The Auditor replied that both these admitted misstatements had no impact on the Balance Sheet or on the Profit and Loss Statement. They affected either Cash Flow Statement or the Related Party Transactions (RPT) disclosures. While drawing attention to para 2 of SA 320 relating to description of the term 'Material', the Auditor contended that admitted misstatement of Rs 68 crores in Cash Flow Statement is not one which could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, for the triviality of amount as compared to overall cash flow of the entity. She further contended that misstatement of Rs 130 crores in RPT disclosure had no significant impact because these were non-funded obligations and only contingent in nature. The Auditor argued that these two omissions would not have constituted material misstatement going by the principles of SA 320.

Analysis of reply

¹⁷ SA 450, Evaluation of Misstatements identified during the Audit.

137 The import of the Auditor's reply is that all transactions have been recorded & accounted for and as such there is no misstatements in the Financial Statements. It would be important to look at the term misstatement as defined in the relevant SA. The term 'Misstatement' is described in para 4(a) of SA 450, as "*A difference between the amounts, classification, presentation, or disclosure of a reported financial statement item and the amount, classification, presentation, or disclosure that is required for the item to be in accordance with the applicable financial reporting framework. Misstatements can arise from error or fraud. When the auditor expresses an opinion on whether the financial statements give a true and fair view or are presented fairly, in all material respects, misstatements also include those adjustments of amounts, classifications, presentation, or disclosures that, in the auditor's judgment, are necessary for the financial statements to give a true and fair view or present fairly, in all material respects*". (Emphasis supplied). The term 'Fraud' is defined in SA 240 as "*An intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage*". It has already been proved that entire borrowings & lending transactions were fraudulent with ulterior motive to divert funds to promoters. Misstatements relating to Finance Cost & Cash Flow Statement have also been proved (It is also partially admitted by the Auditor) and misstatement in issuance of corporate guarantee has also been admitted by the Auditor. These misstatements were clearly the result of fraud or error and their identification in the SCN is in place. The Auditor's reply is a desperate attempt to hide her gross negligence in making audit conclusions and forming an Audit Opinion.

138 The Auditor has further contended that the admitted misstatements of Rs 198 crores (Rs 68 crores + Rs 130 crores) are not material. The Auditor did not respond to non-determination of materiality during the course of audit, which is clearly a non-compliance with SA 320. Further, MACEL had revenue of Rs 1.71 crores, negative net worth of Rs 223.65 crores and assets of Rs 36.01 crores only that were apparently used for business activity of MACEL as rest of the assets were in the form of loans/advances made to related parties for diversion of funds. Keeping in view this relevant financial information that the actual scale of operation of MACEL was very small compared to the funds received through it as a conduit, it is clear that misstatement of Rs 11,393.69 crores in the Financial Statements of MACEL were material misstatements. It is baffling that the Auditor did not find materiality in these staggering figures. In the presence of such pervasive misstatements, the Financial Statements of MACEL for FY 2018-19 did not give true and fair view of its Financial Position as on 31.03.2019, Financial Performance and Cash Flows for the FY 2018-19. Despite this, the Auditor had falsely reported that the Financial Statements of MACEL for FY 2018-19 gave true and fair view of its Financial Position, Financial Performance and Cash Flow. We find that the Auditor was grossly negligent in forming the Audit Opinion, and equally absurd in defending that position, and therefore we conclude that this charge is proved that the Auditor violated SA 320 & SA 700.

D. Other Non-compliances with Laws and Standards

In addition to the lapses detailed in Section- C of the Order, the Auditor was also charged with the following lapses in her audit:

- a) Lapses in audit relating to Internal Financial Control over Financial Reporting

- b) Lapses in audit of compliance with NBFC registration requirement under section 45IA of Reserve Bank of India Act 1934
- c) Violation of Section 143(2) of the Companies Act 2013
- d) Failure to ensure compliance with 134(1) of the Companies Act 2013
- e) Failure to comply with SA 570, Going Concern
- f) Failure to comply with SA 505, External Confirmations
- g) Failure to comply with Standard on Quality Control and SA 230, Audit Documentation
- h) Failure to comply with SA 580, Written Representations

Reply of Auditor

- 139** The Auditor has denied her wrongdoings and professional misconduct in all the charges mentioned in the previous paragraph.
- 140** In respect of auditor's failure to understand the control environment, identify and report absence of adequate effective internal controls and identify potential RoMM due to misuse of bank cheques by a person functioning as de facto management of MACEL, the Auditor has refuted the charges saying NFRA has viewed the principles of SA 315 without considering the limitations associated in assessing efficacy of internal controls and that she had ensured proper authorization of transactions. The issue of cheques by the de facto management was not a matter of absence of internal control but the desire of the majority shareholders. Further, she has asserted that the company did not suffer any losses because of internal financial control issues.
- 141** In relation to violation of RBI requirements on registration of NBFC, the Auditor stated that the MACEL's transactions were only advances and not loans or financial assets which would be considered in evaluating whether an entity is a NBFC.
- 142** There were several errors/omissions in the presentation and disclosures in the financial statements vis-à-vis the requirements of Schedule III (Division I) of the Act. While the Auditor accepted these errors/omissions she also said that these were clerical oversight, inconsequential and not with intent of misstatement. Hence, she asked to be pardoned.
- 143** The Auditor asserted that compliance with section 134 (1) of the Act i.e., approval by the Board of Directors, mentioning the names of the signatories etc. is the responsibility of the Company Management and therefore, she cannot be held responsible for this. However, she had obtained a copy of the minutes pursuant to NFRA's SCN and attached a copy of the same as part of replies to SCN.
- 144** The Auditor asserted that she had relied on para 22 of SA 570 in making a professional judgement on the going concern issue and accordingly, included it in the EOM only.
- 145** The Auditor asserted that obtaining external confirmations is not mandatory, that the external confirmations obtained by the Company are intended by SA 505 and that Bank Statements available with the Company are better audit evidence than mere balance confirmations.

- 146** In respect of the charge relating to delay in submission of audit files or submission of incomplete files, the Auditor has replied that the reasons for the same need to be looked at more objectively by NFRA instead of making surmises. (SA 230)
- 147** The Auditor believes that obtaining written representations is not mandatory as per SA 580. However, she has referred to certain work papers of having obtained written representations.

Analysis of reply

- 148** The Auditor has completely failed to understand the ultimate implications of fraudulent transactions in a closely held entity belonging to the promoters of the listed entity viz. Coffee Day Enterprises Limited (CDEL), which had raised funds from the public at large and borrowed from banks. As mentioned in preceding paras in Section C, MACEL was one of the conduits used by the Promoters of CDEL to siphon off its funds. The Auditor was grossly negligent in understanding the group structure in which the MACEL was operating, thereby failing to appreciate the criticality and significance of the need for robust internal financial controls in MACEL, an unlisted closely company held by promoters of the listed entity. Further, it is alarming to note that the Auditor turned a blind eye to the accounting jugglery in a company by an individual who was neither a shareholder nor a director nor an employee. The accounting jugglery was to misrepresent financial affairs of the company and involved massive amounts. The Auditor's work relating to testing of controls was very casual, and in fact a charade.
- 149** The Auditor's judgment regarding the true nature of 'Advances' given by MACEL is flawed and lacks maturity. The Advances given by MACEL to entities purported to be suppliers of goods/services were in substance 'loans' or 'financial assets' but camouflaged as non-financial assets to avoid the regulatory requirements of financial services sector regulator viz. RBI. The Auditor's much needed professional skepticism was starkly absent here also, as is the case in many other areas discussed in this Order.
- 150** Presentation and disclosures in financial statements are as important as recognition and measurement aspects of the financial statements. When the errors/omissions relate to sensitive items such as borrowings, related party transactions/outstanding amounts, these cannot be wished away as clerical or inconsequential errors/omissions. The Auditor needs to exercise due professional care, which was not the case here.
- 151** The Auditor's attempt to shirk her responsibility to undertake basic checks like whether the Financial Statements signed by her are approved by the Company's Board, is unacceptable. This is not the professional attitude of an Independent Auditor.
- 152** In respect of non-compliance with Auditor's responsibilities under SA 570, there is a 'Knowledge Gap' on the part of the Auditor thereby failing to meet the obligations cast on the Auditor in para 22 read with para A27 of SA 570. These paragraphs require the Auditor to issue modified opinion in the form of either 'Qualified Opinion' or 'Disclaimer of Opinion', if the management is unwilling to make clear disclosure about the going concern assessment. Therefore, she should have considered above provisions when the MACEL's management was

not willing to provide clear disclosure regarding going concern when there were circumstances indicating uncertainty about the company's ability to continue as a going concern.

- 153** SA 505 - While agreeing with the Auditor's averment that obtaining external confirmations is not mandatory, we observe that there is again a serious 'Knowledge Gap' about the relationship between reliability of audit evidence and its source, and audit evidence obtained directly by the auditor is more reliable than that obtained indirectly and so on. It is astonishing to read the Auditor's averment regarding superiority of audit evidence in the form of bank statements versus bank balance confirmations. The Auditor has failed to learn from the recent episodes of catastrophic accounting frauds which remained undetected due to deficient audit procedures¹⁸.
- 154** SA 230 - The Auditor's failure to ensure completeness of the Audit File before submission to NFRA, in respect of an audit completed three years ago, is nothing but lack of professional due care and gross negligence.
- 155** It is important to note the mandatory nature of audit requirement under para 8 of SA 580, which requires that the auditor 'shall' request from appropriate management written representations. Further, the work papers referred to by the Auditor in her reply relate only to the outdated audit work papers on going concern assessment and a letter from an unnamed director clarifying certain queries raised by the Auditor.
- 156** In view of this analysis, the above charges are proved that the Auditor has violated section 143(2) & 143(3)(i) of the Act, CARO, SQC 1, SA 230, SA 505, SA 570, SA 580 and failed to ensure whether MACEL had complied with section 134(1) of the Act. The charge regarding the auditor's failure to report non-constitution of Audit Committee is dropped in view of the satisfactory reply given by the Auditor.

E. Omissions and commissions by the Audit Firm

- 157** The Audit Firm was charged with various omissions and commissions observed in the audit, as discussed in the preceding paragraphs, for its role as the statutory auditor appointed under section 139 of the Act.
- 158** The Audit Firm was also charged with failure to comply with para 2 of SA 220 and para 3 of SQC 1, which stipulate that Quality Control Systems, Policies and Procedures are the responsibility of the Audit Firm. The Audit Firm was also charged with failure to establish and maintain a system of quality control to provide it with reasonable assurance that:
- a) The firm and its personnel comply with professional standards and regulatory and legal requirements; and
 - b) The reports issued by the firm or engagement partners are appropriate in the circumstances.
- 159** Responding to this charge, CA Lavitha Shetty, Proprietor of the Audit Firm stated that "*the Audit Firm in this case is the proprietary firm of the respondent, therefore it has no independent*

¹⁸ E.g., Satyam Computers Limited (2008) and Wirecard, Germany

existence separate from the proprietor. Therefore, no additional or separate charges on the Audit Firm is tenable”.

160 While replying to individual charges, the Auditor denied all the articles of charges. We have already examined the pointwise reply and found that all charges are proved except the charge relating to constitution of the Audit Committee. Therefore, CA Lavitha Shetty, Proprietor of the Audit Firm is also responsible for non-compliance with provisions relating to Quality Control Systems, Policies and Procedures of SA 220 and SQC 1 as mentioned in the paragraphs above.

F. Articles of Charges of Professional Misconduct by the Statutory Auditor:

161 As discussed in the preceding paragraphs, the Auditor has made a series of serious departures from the Standards and the Law, in conduct of the audit of MACEL for FY 2018-19. Based on the above discussion, it is proved that the Auditor had issued unmodified audit opinion on the Financial Statements without reporting diversion of funds, evergreening of loans and committed other serious lapses during performance of audit. Based on the foregoing discussion and analysis, we conclude that the Auditor has committed Professional Misconduct as defined in Section 132 (4) of the Companies Act, read with section 22 the Chartered Accountants Act 1949 (the CA act), as amended from time to time, and listed as below:

- i. The Auditor committed professional misconduct as defined in clause 5 of Part I of the Second Schedule of the CA Act, which states that an EP is guilty of professional misconduct when she "fails to disclose a material fact known to her which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where he is concerned with that financial statement in a professional capacity". This charge is proved as the Auditor failed to disclose in the Audit Report the material non-compliances the Company made as explained in Section C, and Section D (a, b, c and d) above.
- ii. The Auditor committed professional misconduct as defined in clause 6 of Part I of the Second Schedule of the CA Act, which states that an EP is guilty of professional misconduct when she "fails to report a material misstatement known to her to appear in a financial statement with which she is concerned in a professional capacity". This charge is proved as the Auditor failed to disclose in the Audit Report the material misstatements made by the Company as explained in Section C, and Section D (a, b, c and d) above.
- iii. The Auditor committed professional misconduct as defined in clause 7 of Part I of the Second Schedule of the CA Act, which states that an EP is guilty of professional misconduct when she “does not exercise due diligence or is grossly negligent in the conduct of her professional duties”. This charge is proved as the EP failed to conduct the audit in accordance with the SAs and applicable regulations, failed to report the material misstatements in the financial statements arising from diversion of funds, circulation of funds and failed to report non-compliances made by the Company, as explained in Section C, D and E above.

- iv. The Auditor committed professional misconduct as defined in clause 8 of Part I of the Second Schedule of the CA Act, which states that an EP is guilty of professional misconduct when she “fails to obtain sufficient information which is necessary for expression of an opinion or its exceptions are sufficiently material to negate the expression of an opinion”.

This charge is proved as the Auditor failed to conduct the audit in accordance with the SAs and applicable regulations as well as failed to obtain sufficient appropriate audit evidence resulting in her total failure to report the material misstatements and non-compliances made by the Company in the financial statements, as explained in Section C, D and E above.

- v. The Auditor committed professional misconduct as defined in clause 9 of Part I of the Second Schedule of the CA Act, which states that an EP is guilty of professional misconduct when she “fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances”.

This charge is proved since the Auditor failed to conduct the audit in accordance with the SAs as explained in Section C, D and E above.

162 PCAOB¹⁹ in a similar matter of diversion of funds to a related party, observed that “*The transactions between one of the Issuer’s wholly-owned Chinese subsidiaries (“Subsidiary”) and a Chinese purchasing agent (“Agent”) involved the Subsidiary’s transfers of loan proceeds to the Agent as prepayments to buy equipment and materials that the Agent never delivered. The loans were obtained from Chinese lenders for the purpose of making these purchases. While the Agent returned a portion of the prepayments some in unusual same-day, round-trip transfers it did not return most of them”*.... “*By failing to adequately respond to the known fraud risks, Marcum’s engagement team breached its duty to perform the Audits with the due professional care and professional skepticism required by PCAOB standards. The team also failed to adequately understand the business rationale (or the lack thereof) for the significant unusual transactions and failed to obtain sufficient appropriate audit evidence to support Marcum’s opinion on the Issuer’s financial statements*”. For this misconduct, PCAOB censured Marcum LLP (“Marcum”); imposed a civil money penalty of \$250,000 on Marcum; prohibiting Marcum, for a period of three years from the date of this Order, from issuing an audit report for an issuer client with substantially all of its operations in the People’s Republic of China; and requiring Marcum to undertake a review of its quality control policies and procedures regarding initial acceptance of, and audits performed for, certain issuer clients. Further, PCAOB censured John E. Klenner, CPA (“Klenner”); barred Klenner from being an associated person of a registered public accounting firm, but allowed Klenner, after two years, to petition the Board for consent to associate with a registered firm; in the event Klenner seeks and the Board grants consent for him to associate with a registered firm, prohibited him from serving as an engagement partner or engagement quality reviewer on issuer audits for a one year period after the Board grants consent for him to associate with a registered firm; imposed a civil money penalty of \$25,000; and required Klenner to complete forty hours of continuing professional education (“CPE”), in addition to any CPE required in connection with any professional license, before filing a petition for Board consent to associate with a registered firm.

¹⁹ PCAOB Release No. 105-2020-012 and PCAOB Release No. 105-2020-013 both dated 24.09.2020.

- 163** Similarly, failures to perform audit procedures and exercise professional skepticism in related parties transactions and internal control over financial reporting have invited serious action by audit regulators in other jurisdictions too. For example, in case of Cheryl L. Gore, CPA and Stanley R. Langston, CPA, PCAOB²⁰ had observed that “*Gore failed to obtain sufficient appropriate audit evidence and to perform sufficient procedures concerning whether Issuer A’s financial statements accurately disclosed its related party transactions*”..... “*Gore failed to exercise due professional care, including professional skepticism, and failed to obtain sufficient appropriate audit evidence in connection with Issuer A’s identification, accounting, and disclosure of related party relationships and transactions..... Specifically, as part of her risk assessment procedures, she was required to obtain an understanding of the design and implementation of Issuer A’s internal control over financial reporting (“ICFR”) in connection with related parties, to evaluate the design of those controls that were relevant to the audit, and to determine whether those controls had been implemented. Gore failed to perform any of these procedures during the 2016 Audit*””. This case resulted in debarment and imposition of monetary penalty on the auditors.
- 164** In a matter relating to impairment allowance for loans in the case of Grant Thornton LLP, PCAOB²¹ had observed “*Grant Thornton, among other things, failed to exercise due professional care, including appropriate professional skepticism, and failed to obtain sufficient appropriate audit evidence concerning the reported value of Bancorp’s net loans, the effectiveness of Bancorp’s controls relating to its allowance for loan a known significant risk and significant accounting estimate. As a result of its failures to perform the audit in conformity with PCAOB standards, Grant Thornton failed to obtain sufficient appropriate audit evidence to support its audit opinions on Bancorp’s financial statements and ICFR*”. For misconducts including this one, PCAOB censured Grant Thornton LLP ("Grant Thornton"), imposed on Grant Thornton a civil money penalty in the amount of \$1,500,000; and required Grant Thornton to undertake certain remedial actions.
- 165** In the Matter of Richard H. Huff, Jr., CPA, (partner of Grant Thornton LLP) PCAOB²² has observed that “*Huff also failed to obtain sufficient appropriate evidence in connection with certain specific loan reviews because he (a) repeatedly ignored red flags or contradictory evidence indicating that loans may have been improperly risk rated, impaired, and/or require reserves; (b) repeatedly relied on management representations without obtaining relevant and reliable evidence to corroborate those representations; and (c) failed to identify and evaluate potential control deficiencies*”. For this violation, PCAOB censured and suspended Engagement Partner from being an associated person of a registered public accounting firm.

G. PENALTY & SANCTIONS

- 166** Section 132(4) of the Companies Act, 2013 provides for penalties in a case where professional misconduct is proved. The seriousness with which proved cases of professional misconduct are viewed, is evident from the fact that a minimum punishment is laid down by the law.

²⁰ PCAOB Release No. 105-2021-020 dated 14.12.2021.

²¹ PCAOB Release No. 105-2017-054 dated 19.12.2017.

²² PCAOB Release No. 105-2019-001 dated 26.02.2019.

- 167 The Auditor was required to ensure compliance with Standards on Auditing, Laws and Regulations to achieve the necessary audit quality and lend credibility to Financial Statements to facilitate its users. As detailed in this order, substantial deficiencies in Audit, abdication of responsibility and inappropriate conclusions on the part of the Auditors establish her professional misconduct and lack of due diligence. Despite being a qualified professional, the Auditor has not adhered to the Standards and have thus not discharged the duty cast upon her.
- 168 Section 132(4)(c) of the Companies Act 2013 provides that National Financial Reporting Authority shall, where professional or other misconduct is proved, have the power to make order for
(A) imposing penalty of (I) not less than one lakh rupees, but which may extend to five times of the fees received, in case of individuals; and (II) not less than ten lakh rupees, but which may extend to ten times of the fees received, in case of firms;
(B) debaring the member or the firm from (I) being appointed as an auditor or internal auditor or undertaking any audit in respect of financial statements or internal audit of the functions and activities of any company or body corporate; or (II) performing any valuation as provided under section 247, for a minimum period of six months or such higher period not exceeding ten years as may be determined by the National Financial Reporting Authority.
- 169 As per information furnished by M/s Lavitha & Associates vide letter dated 28.07.2022 and dated 07.02.2023, the statutory audit fee of MACEL for FY 2018-19 was Rs [REDACTED], Further, the Audit Firm received total professional fees of Rs [REDACTED] from Coffee Day Group entities in respect of services rendered for FY 2018-19. Total professional fees received the Audit Firm during FY 2018-19 was Rs [REDACTED].
- 170 Considering the proved professional misconduct, the nature of violations and principles of proportionality, we, in exercise of powers under Section 132(4)(c) of the Companies Act, 2013, hereby order:
“Imposition of a monetary penalty of Rs Five Lakhs only upon CA Lavitha Shetty. In addition, CA Lavitha Shetty is debarred for a period of five years from being appointed as an auditor or internal auditor or from undertaking any audit in respect of financial statements or internal audit of the functions and activities of any company or body corporate”.
- 171 This order will become effective after 30 days from the date of issue of this order.

Signed
(Dr Ajay Bhushan Prasad Pandey)
Chairperson

Signed
(Dr. Praveen Kumar Tiwari)
Full-Time Member

Signed
(Smita Jhingran)
Full-Time Member

Date: 13.04.2023

Place: New Delhi

Order in the matter of MACEL (Coffee Day Group Company) for the FY 2018-19

एनएफआरए के कार्यकारी निकाय द्वारा जारी करने के लिए अधिकृत

(विद्युत मूद्र)

सचिव, एनएफआरए

सचिव / Secretary
राष्ट्रीय वित्तीय रिपोर्टिंग प्राधिकरण
National Financial Reporting Authority
नई दिल्ली / New Delhi

To,
CA Lavitha Shetty,
(ICAI Membership No. 220473)
Proprietor of M/s Lavitha & Associates,
Chartered Accountants,
(ICAI Firm Registration No: 011882S)
Address- Raya Agencies, Raganna Choultry Complex,
Basavanahalli Main Road,
Chikkamagaluru-Pincode: 577101.
Karnataka.
E-mail: calavithas@gmail.com

Copy To: -

- (i) Secretary, Ministry of Corporate Affairs, Government of India, New Delhi.
- (ii) Securities and Exchange Board of India, Mumbai.
- (iii) Secretary, Institute of Chartered Accountants of India, New Delhi.
- (iv) Mysore Amalgamated Coffee Estate Limited, Chikkamagaluru.
- (v) IT-Team, NFRA for uploading the order on the website of NFRA.