

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

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सातवीं मंजिल, हिंदुस्तान टाइम्स हाउस,
कस्तूरबा गांधी मार्ग, नई दिल्ली

मिसिल संख्या : NF-23/14/2022

दिनांक: 25.04.2023

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 10th November 2022, issued to CA Lavitha Shetty, proprietor of M/s Lavitha & Associates (ICAI Firm registration no. 011882S), Chikkamagaluru, who is a member of the Institute of Chartered Accountants of India ('ICAI' hereafter) and was the Engagement Partner ('EP' or 'Auditor' hereafter) for the statutory audit of Mysore Amalgamated Coffee Estates Limited, ('MACEL' or 'the company' hereafter) Chikkamagaluru, for the Financial Year ('FY' hereafter) 2019-20.
- 2 This Order is divided into the following sections:
 - A. Executive Summary.
 - B. Introduction & Background.
 - C. Major lapses in audit of fraudulent borrowings, diversion of funds, evergreening of loans and related matters.
 - D. Other non-compliances with Laws and Standards.
 - E. Omissions and commissions by the Audit Firm.
 - F. Articles of Charges of Professional Misconduct by the Auditor.
 - G. 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 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 Companies Act 2013 ('the Act' hereafter).
- 4 NFRA's investigations inter-alia revealed that the MACEL's Auditor for the FY 2019-20 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 & skepticism during audit of fraudulent borrowings of Rs. 4,438.37 crore from Banks & Related Parties and its use for fraudulent diversion of Rs. 4,176.67 crore 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 Transactions involving an

accounting fraud orchestrated by issue of cheques at the end of FY 2018-19 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. The EP failed to exercise professional skepticism during the audit of inappropriate recognition of finance cost of Rs 40.47 crores for the borrowings that were 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 1,938.87 crores. The EP failed to evaluate corporate guarantees issued by MACEL and creation of charges on its assets to facilitate borrowings of Rs 130 crores taken by the wife of V.G. Siddhartha (chairman of CDEL, the listed company of the coffee Day group) and one other related party. Thus, despite material and pervasive misstatement of Rs 10,724.38 crores in the Financial Statements of MACEL, the EP did not report these misstatements.

5 The EP did not report that Internal Financial Control over Financial Reporting was absent, despite pre-signed blank cheques being used by V.G. Siddhartha ('VGS' hereafter), who was neither a shareholder nor a director nor an employee of MACEL, for diversion of funds to other group entities. Besides these, the EP violated a number of Standards on Auditing and Accounting Standards.

6 The EP contended that she became aware of the possible financial mismanagement only after learning about the death of VGS (in July 2019) and the contents of the letter he left behind. Consequent to that she had issued Disclaimer of Opinion indicating non recoverability of advances made by MACEL. The Standards on Auditing do not absolve an Auditor from the responsibility of reporting other misstatements once a disclaimer on a particular aspect is given. It was found that the EP had failed in her statutory duty and had tried to hide behind one disclaimer of opinion, which itself was incomplete as she did not cover all aspects of infraction of the Laws and the Standards.

7 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 - CA Lavitha Shetty, guilty of professional misconduct and imposes through this Order the following monetary penalties and sanctions that will take effect after a period of 30 days from issuance of this Order:

- a) Imposition of a monetary penalty of Rs Ten Lakhs;
- b) Debarment for a period of Ten 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. The first five years out of the ten years debarment ordered, would run concurrently with the period of debarment ordered vide NFRA order dated 13.04.2023 in the case of CA Lavitha Shetty.

B. INTRODUCTION & BACKGROUND

8 The National Financial Reporting Authority is a statutory authority set up u/s 132 of the Companies Act 2013 ('Act' hereafter) to monitor implementation and enforce 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 proven professional or other misconduct of the individual members or firms of Chartered Accountants.

- 9 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 ('SQC' hereafter) and the Code of Ethics, the violation of which constitutes professional misconduct, and is punishable with penalty prescribed u/s 132 (4) (c) of the Act.
- 10 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 section 132 (4) of the Companies Act 2013.
- 11 Late V. G. Siddhartha 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. Out of total acreages of coffee estates owned by the group, MACEL owned 578 acres of coffee plantations and 91.75% shares of MACEL were held by Late S.V. Gangaiah Hegde, the father of VGS.
- 12 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 had increased to Rs 3,535 crores on 31 July 2019, detailed as under in Table 1-

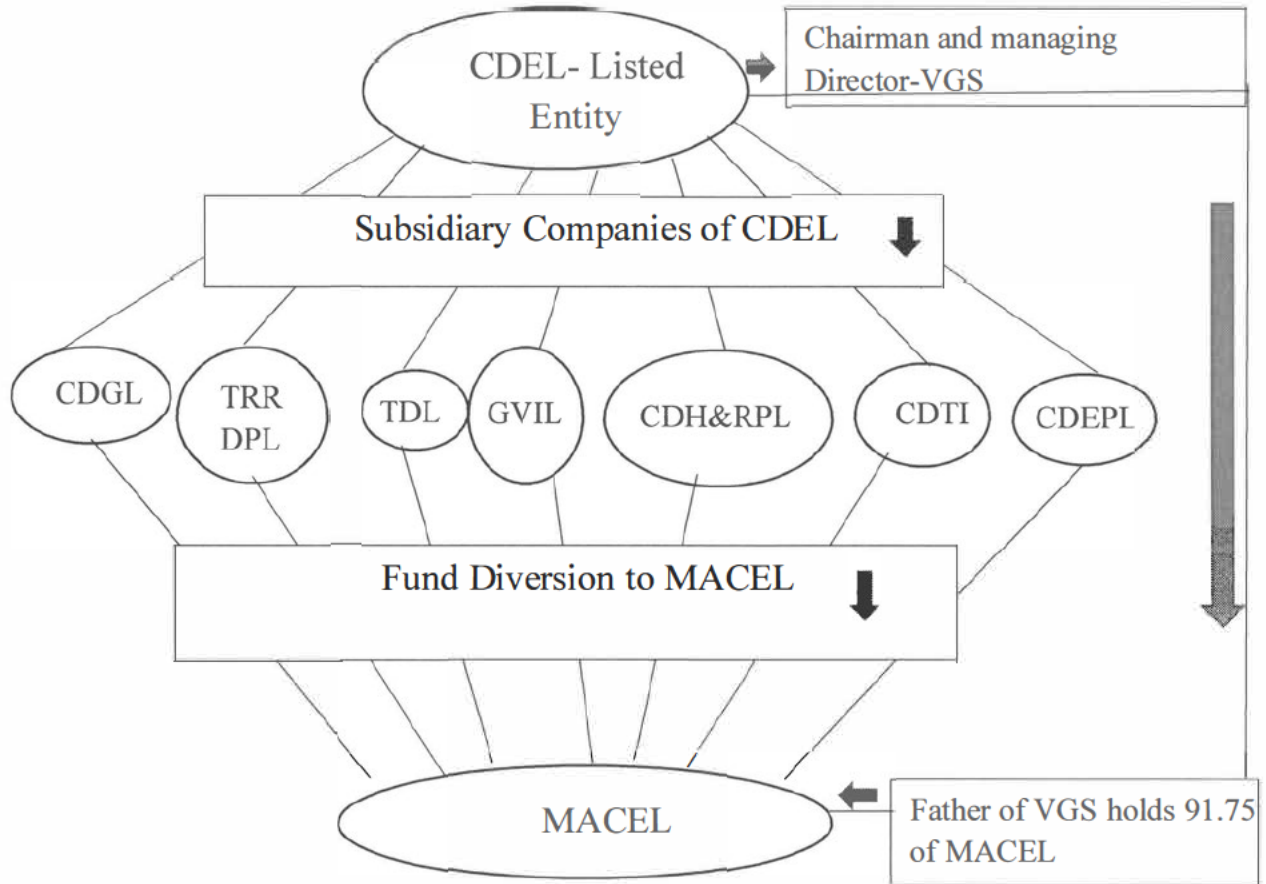
Table-1 (Rs in crores)

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

¹ Rule 3 of The NFRA Rules 2018.

13 The linkage of the entities described in above Table is depicted in the chart given below:

Chart-1:



- 14 As per the Financial Statement of MACEL, funds were further transferred from MACEL to the personal accounts of VGS, his relatives and entities controlled by him and/or his family members, whose outstanding balances receivable by MACEL were Rs 3,401.66 crores as on 31-03-2020. On examination of Financial Statement of MACEL, it transpired that MACEL did not have any business transaction with 6 of the 7 subsidiary companies of CDEL except CDGL; and that MACEL was used as a conduit to fraudulently transfer funds from the subsidiary 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.
- 15 The modus operandi of the alleged diversion of funds discovered during SEBI investigation was that “VGS used to ask the Authorised Signatories to sign bunch of cheques which was 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.
- 16 M/s Lavitha & Associates is a proprietary firm registered with ICAI carrying on the profession of chartered accountancy from Chikkamagaluru city in the state of Karnataka. The Audit Firm was statutory auditor of MACEL for FY 2019-20 and 2018-19 and Ms Lavitha Shetty was Engagement Partner (‘EP’ hereafter) for this audit engagement. The Firm was also statutory auditor of Coffee Day Hotels & Resorts Private Limited (CDH&RPL) for FY 2019-20 and Rs 155 crores was diverted from CDH&RPL to MACEL during FY 2019-20. NFRA vide its order dated 13.04.2023 has held Ms Lavitha Shetty guilty of professional misconduct for the audit of MACEL for the FY 2018-19.

- 17 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.
- 18 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 the immediately preceding financial year. MACEL is an unlisted Public Company having borrowings of Rs 4,112.47 crores as on 31-03-2019, therefore, it falls under the jurisdiction of NFRA for the FY 2019-20 and its financial statements are to be prepared in accordance with Accounting Standards and the relevant Laws.
- 19 NFRA called from the statutory auditor the Audit File for the audit of Financial Statements ('FS' hereafter) of MACEL for Financial Year 2019-20 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) on 10.11.2022 asking the Statutory Auditor (EP) to show cause by 10.12.2022 why penal provisions of section 132(4)(c) of the Companies Act 2013 should not be invoked for professional misconduct of:
- 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.
 - 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.
 - Failure to exercise due diligence and being grossly negligent in the conduct of professional duties.
 - 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
 - Failure to invite attention to material departure from the generally accepted procedures of audit applicable to the circumstances.
- 20 After availing extension of time, the EP vide letter dated 03.01.2023 submitted reply to SCN.
- 21 The SCN also gave an opportunity of personal hearing to the EP, 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 EP and other materials available on record.

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

Examination of General submission by the EP

- 22 The EP has stated in preliminary submission that she had issued a 'Disclaimer of Opinion' in accordance with SA 705, Modifications to the Opinion in the Independent Auditor's Report. While inviting attention to para 9 of this SA, which states '*A disclaimer of audit opinion is issued when an auditor is unable to obtain sufficient appropriate audit evidence, to form the basis of an audit*

opinion, and at the same time believes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive, she replied that the Audit Report issued by her had unequivocally communicated that the Financial Statements of MACEL for FY 2019-20, attested by her, contained possible material and pervasive misstatements, but specifics of which were not possible to be determined for absence of audit evidences and hence a disclaimer of opinion was given. While drawing attention to para A7 of SA 230, Audit Documentation, which provides that it is neither necessary nor practical to document every matter considered, or professional judgement made, in an audit, she argued that where an auditor has issued a disclaimer of audit opinion, no further audit documentation is necessary to prove whether the Auditor had undertaken due process to arrive at her view.

23 The EP further replied that in the ‘Basis of disclaimer of opinion’ section of the Independent Auditor’s Report, she had drawn attention to note no-19 of the Financial Statements that sufficient appropriate audit evidence could not be obtained to enable her taking a view over the recoverability of the advances worth Rs 3401.66 crores from Late V G Siddhartha, his associated entities and relatives. She argued that once an auditor concludes after assessing the possibility of Risk of Material Misstatement (‘RoMM’ hereafter) with respect to a significantly material line items in the Financial Statements, then there is no need for the Auditor to carry out any further examination of any of the other line items in the same Financial Statements, because such an examination is inconsequential, and the audit opinion would always remain a ‘disclaimer of audit opinion’ in all circumstances. She further replied that when the audit opinion issued was an ‘expression of inability to issue an audit opinion’, the Auditor is not accountable for any other elements in the Financial Statements, whether present or missing.

24 We have considered this submission. As per para 27 of SA 705, the Auditor is required to report all matters having material effect on the financial statements as it states that *“Even if the auditor has expressed an adverse opinion or disclaimed an opinion on the financial statements, the auditor shall describe in the basis for opinion section the reasons for any other matters of which the auditor is aware that would have required a modification to the opinion, and the effects thereof”*. Its explanatory material at para A24 further explain this matter as *“An adverse opinion or a disclaimer of opinion relating to a specific matter described within the Basis for Opinion section does not justify the omission of a description of other identified matters that would have otherwise required a modification of the auditor’s opinion. In such cases, the disclosure of such other matters of which the auditor is aware may be relevant to users of the financial statements”*.² Thus it is very clear that in case an auditor gives disclaimer of opinion for one matter, it does not mean that the auditor will be free of responsibilities for other unreported material deficiencies/ misstatements in the financial statements. It is important that the Auditors report all material misstatements so that the impact of all misstatements on the financial statements is known and the users of financial statements are not under the misleading impression that the financial statements carry only the reported misstatements. Therefore, we cannot accept this submission of the EP.

² Appendix to SA 705 has an illustration of an Auditor’s report containing a disclaimer of opinion due to the Auditor’s inability to obtain sufficient appropriate audit evidence about multiple elements of the financial statements. This further clarifies that all elements containing material misstatements are to be reported in the basis of disclaimer of opinion.

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

- 25 The EP was charged³ 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. She was also charged with failure to exercise Professional Judgment and Professional Skepticism in planning and performing audit of Financial Statements as required by SA 200⁴. Had the EP obtained an 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 worth Rs 4,176.67 crores on Assets side of the Balance Sheet and Rs 4438.37 crores on the Liability side of the Balance Sheet. These misstatements were a result of fraudulent borrowing mainly from related parties, which were used for fraudulent lending to promoters, their family members and entities owned/controlled by them.
- 26 The SCN noted that MACEL received funds from seven subsidiary companies of CDEL despite the fact that it did not have any business relationship with six of these seven subsidiary companies except CDGL, the sole buyer of coffee beans produced by MACEL. As per the Financial Statements of MACEL, its borrowings of Rs 4,479.79 crores constituted 99.94% of total liabilities of Rs 4,482.40 crores, while 99.01% of its total assets of Rs 4,218.09 crores were the loans & advances given worth Rs 4,176.67 crores. While MACEL had meagre Revenue from Operations of Rs 3.27 crores & Other Income of Rs 0.15 crores only, its Finance cost was Rs 40.47 crores which constituted 91.89% of the total cost of Rs 44.04 crores. The loss incurred by MACEL during the year was Rs 40.62 crores and MACEL had a negative Net worth of Rs 264.32 crores. All the above stated borrowings (except bank borrowings of Rs 160.02 crores) and lending of MACEL were interest free, payable on demand and not supported by any contract/agreement.
- 27 The Financial Statements, according to the SCN, indicated that the majority of the related party borrowings was from subsidiary companies of CDEL (Table 2) and was further diverted to the personal accounts of the Promoters, their family members and entities controlled by them (Table 3).

Table-2

Rs in crores

Loans from subsidiary companies of CDEL (Related Parties) taken by MACEL		
Sr No	Name of company from whom loans were taken	Total outstanding as on 31.03.2020
1	Tanglin Retail Realty Development Pvt Ltd	1,050.31
2	Coffee Day Global Ltd	1,084.01
3	Tanglin Development Ltd	607.54

³ See para 11(b) of SA 315- "Identifying and assessing the risk of material misstatement through understanding the entity and its environment",

⁴ Para 16 of SA 200 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'.

4	Coffee Day Trading Ltd	125.00
5	Coffee Day Hotels & Resorts Pvt Ltd	136.96
6	Giri Vidhyut (India) Ltd	370.00
7	Coffee Day Econ Pvt Ltd	103.20
	Total	3,477.02

Table-3

Name of promoter's family members to whom loans were given	Rs in crores
Sri V G Siddhartha (VGS), Smt Malavika Hegde (wife of VGS) and partnership firm in which he/she is a partner	3,390.56
Sri S V Gangaiah Hegde (Father of VGS)	4.85
Smt Vasanthi Hegde (Mother of VGS)	6.25
Total	3,401.66

28 According to the SCN, it can be observed from Tables-2 and 3 above that the loans & advances taken by MACEL were not for the business activities of the company but for onward lending to the related parties. Out of the total assets of Rs 4,218.09 crores, only Rs 41.42 crores appeared to have been used for business activity and remaining Rs 4,176.67 crores (99.01%) was diverted as Loans & advances, resulting in material and pervasive misstatement on the Assets side of the Balance Sheet⁵. Similarly, out of the total Liabilities of Rs 4,482.40 crores, borrowings were Rs 4,479.79 crores (99.94%). Keeping in view that the assets of only Rs 41.42 crores appeared to have been used for business activity, the rest of the borrowings of Rs 4,438.37 crores (Rs 4,479.79 crore - Rs 41.42 crore), i.e., 99.07% 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 and MACEL was used mainly 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.

29 The SCN noted that SA 200 requires an auditor to exercise professional judgement and skepticism while planning and performing audit. Para 5 of SA 315 requires an Auditor to perform risk assessment procedures to identify and assess Risk of Material Misstatements ('RoMM' hereafter). As per para 5 of SA 330, the Auditor was required to respond to the assessed RoMM. SA 240 prescribes an Auditor's responsibilities relating to fraud in audit of Financial Statements. Para 10 of SA 240 provides that the objectives of an auditor are to identify and assess the RoMM in the

⁵ 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 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".

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 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. While the financials of MACEL indicated that it had abnormally high amounts of transactions in loans and advances and balances with Related Parties, which was outside the normal course of business of the company and presented strong indicators that MACEL was being used by the promoters for diversion of funds from subsidiary companies of CDEL to promoters, their family members and entities controlled by them, there was no evidence to indicate that the EP had performed the basic audit procedure to understand the nature of business of MACEL, and to identify and respond to RoMM due to fraudulent diversion of funds. The SCN charged that the EP failed to comply with SA 200, SA 240, SA 315 & SA 330.

- 30** The SCN noted that the Director of MACEL admitted on 30.05.2019 (letter available in the Audit File of 2018-19) that funds were received from group entities for development and maintenance of coffee plantations, which were payable on demand but no agreements had been signed. She also admitted that loans and advance given to group entities were payable on demand, that no agreements were signed and that the account of the group was being maintained as a running account. These admissions together with the financial information in Table-3 were strong indicators of fraudulent diversion of funds. Had the EP applied professional judgment and skepticism to the admitted facts that no agreements were signed for the financial arrangements involving substantial funds, huge loans were payable on demand and that the group accounts were maintained as running accounts, she could have found the material misstatements and fraud. Therefore, the EP was charged with failure to exercise due diligence in evaluating the said Management letter during audit of the Financial Statements for FY 2019-20.
- 31** The SCN stated that the EP's lack of due diligence was also a violation of Section 143 (12) of the Act under which she had the Statutory duty to report an offence of fraud to the Central Government. However, she reported⁶ that no material fraud by or on the company had been noticed or reported during the course of audit. It was also a violation of the Companies (Auditors Report) Order 2016 ('CARO' hereafter), as she ignored the strong indicators of fraud including the receipt and disbursal of loans and advances without any business rationale, complete absence of internal control and violation of the provisions of the Act.
- 32** As per the Audit File for FY 2018-19, MACEL, in its extraordinary general meeting held on 13.02.2019, had passed two special resolutions authorizing the Board of Directors to borrow 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. As per section 179 of the Act, while the Board of Directors has powers to borrow funds and grant loans, there is no evidence in the Audit File that the Board of Directors had approved any resolution for borrowing and giving funds as loans and advances, as required under section 179(3) of the Act. The EP was accordingly charged for not verifying whether MACEL had complied with provisions of section 179(3) of the Act.

⁶Para X of Annexure -A (CARO report) of Independent Auditor report dated 02.12.2020.

- 33 Diverting funds fraudulently to personal accounts of VGS, 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)⁸. As the EP 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 she was charged with violating SA 250 - 'Consideration of Laws and Regulations in an Audit of Financial Statements'.

Reply of the EP

- 34 While denying the charge, the EP has replied that she had issued a 'disclaimer of opinion', which is evidence that she had exercised professional judgement and professional skepticism. Accordingly, there was no noncompliance with SA 200. She further replied that during the audit of FY 2018-19, she had no occasion to suspect that anything was amiss in the functioning of MACEL because the management actions were professional and under the control and overall supervision of the shareholders. Therefore, she issued an unmodified audit report with an Emphasis of Matter paragraph over 'going concern assumption'. However, during FY 2019-20, VGS passed away leaving behind a note that he had not disclosed many facts about the financial mess of the group to anyone including the Auditors. According to the EP, based on that information, she changed her view during FY 2019-20 and issued a disclaimer of audit opinion. She also stated that the borrowings and advances made as appearing in financial statements of FY 2019-20 were the effect of the carried over numbers of FY 2018-19 and that 'Additional transactions on FY 2019-20 were collateral and rotational effects'.
- 35 In respect of compliance with SA 200 and SA 315, the EP replied that advancing of huge amounts to related parties and consequent outstanding balances as reflected in the Financial Statements did not pose any risk of material misstatement as these were the effect of actual transactions. The EP replied that she obtained a fair knowledge of the entity, its environment, financial reporting system and internal controls during the Audits of earlier years. She claimed to have performed risk assessment procedure as recorded at page 157-158 of the Audit File forming part of annexure to SCN and that her assessment of internal finance control policy was available on page 181-182 of the Audit File forming part of annexure to SCN. She further replied that the transactions happened during FY 2018-19, and were not outside the normal course of business as she did not suspect the explanation given by management that promoters were looking after about 10000 acres of coffee estates and the advances in question were in furtherance of their coffee business. She stated that the money received from the subsidiary companies of CDEL, and advances granted to accounts of promoters were to achieve this objective. However, during FY 2019-20, from the note of VGS, she realized that the explanations given about the objective of the advances were perhaps not true.

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.

⁸ As 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'.

Suspecting doubt in recoverability of advances and absence of proper audit evidence, she gave a disclaimer of opinion, which was evidence of her compliance with SA 200, SA 315 and SA 330.

36 While not disputing the facts given in Tables 2 and 3 regarding borrowings and advances made to Related Parties, the EP 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 promoters because such findings can emerge only from an investigation and are not capable of being detected within the scope of work of a Statutory Auditor.

37 While responding to the charge relating to failure to verify whether borrowings & lending were approved by the Board of Directors in accordance with section 179(3) of the Act, she replied that there is no reporting obligation on an Auditor under section 179(3) and section 180 of the Act and 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”.

38 Responding to the charge relating to noncompliance with SA 240, the EP replied that borrowings and lending were for furtherance of business interest of MACEL and were not outside the normal course of business, thus they do not constitute fraud and misappropriation of funds. There was no error or omission in the presentation of transactions in the Financial Statements. The EP further replied that the cash flow management was under the control of VGS. One can criticize it as poor corporate governance but does not make a case of fraudulent acts. The EP further stated that the absence of agreements for advances given, does not make out a case of transactions given with fraudulent intentions. MACEL was in a liquidity trap and recovery of advances made was doubtful, therefore she had given disclaimer of opinion.

39 Responding to the charge relating to noncompliance with section 143(12) of the Act, the EP replied that no investigating agency has termed these transactions as fraudulent and she had no doubt about the sincerity of purpose of the Management of CDEL. There was no misappropriation of assets, no falsification of accounts and no concealment of any transactions in the Financial Statements, therefore she did not suspect any fraud or misappropriation of funds and it was a false allegation that the EP knew that funds were being diverted to personal accounts of promoters. She further stated that an Auditor is not skilled to detect fraud; and that VGS, holding 91% shares, carried out the transactions, and hence the issue was not about absence of internal control.

40 Responding to the charge relating to violation of PMLA, the EP replied that she had no knowledge that these transactions were fraudulent diversion of funds; and that there were no findings by any authority that such transactions fell within the definition of section 420 of IPC or section 3 of PMLA.

Analysis of reply

41 We observe that MACEL's revenue from operations was Rs 3.27 crores in 2019-20, it had tangible assets of Rs 41.42 crores and negative net worth of Rs 264.32 crores. It did not have any expansion plan. From these numbers it would be evident to any prudent person that a company like MACEL did not need huge borrowings of 4,479.79 crores and lending of Rs 4,176.67 crores for its business. The EP has confessed that during the Audit for FY 2018-19 she had completely relied upon the explanations given by the Management that huge amounts of borrowings from related parties and

lending to related parties were for furtherance of coffee business of associated entities. MACEL was not a financial institution, therefore routing of such huge amounts through it cannot be termed to be in the ordinary course of business of MACEL, as it did not have any business relationship with such associated entities from which it received and to which it lent money. Therefore, before relying on the management explanation, the EP was required to evaluate the business purpose behind such huge borrowing and lending transactions of MACEL with related parties. But this was not done.

- 42 On compliance with Section 179(3) of the Act, we find that the section empowers the Board of Directors (Board) to exercise powers relating to borrowing and lending of money, by means of resolutions passed in 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 a provision, is to ensure that no unauthorized borrowings and lending is entered into by the management. In this case the EGM authorised the Board to take decisions on borrowings and lendings up to a monetary limit. This empowered the Board to pass resolutions for transactions within the set limit. But the Board passed no resolution authorising the said transactions, thus rendering the transactions in question 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 EP that the approval of financial statements by the Board of Directors (done under section 134(1) of the Act) is evidence that all the transactions in it have the stamp of approval of the Board of Directors, is astonishing. This shows a total lack of understanding of what an 'authorisation of transaction' by the Board means. Such a flawed understanding by the EP, who is entrusted to check adherence to Standards and the Laws, is alarming and disconcerting. It appears that the EP has furnished this absurd reply to cover up her deficiency during performance of Audit of MACEL.
- 43 It is an undisputed fact that all the loans and advances were without any written Contract/Agreement and were repayable on demand. There is no material on record to show whether any Security was obtained before giving such huge amounts of loans/advances. Despite knowing these adverse indicators, the EP did not evaluate the business rationale of these huge transactions with related parties. Needless to say, every Auditor should be aware that Related Party Transactions have a high potential of misuse/misstatement, as is also reflected in the special provisions in law to monitor and regulate them.
- 44 Based on above analysis, we find that funds were fraudulently borrowed from subsidiary companies of CDEL with the ulterior motive to fraudulently divert such funds to the personal accounts of promoters, their family members and entities owned/controlled by them.
- 45 The Audit work papers quoted by the EP have been perused. On verification of page 157 of the Audit File forming part of annexure to SCN, we see that it is a statement prepared by MACEL containing some basic details about the company like nature of business and operational heads of the company. Page 158 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 any risk assessment procedure performed by the EP. Page 181 and 182 are the Internal Financial Control Policy prepared by MACEL containing high level general information about separation of duties, authorization & approval, custodial & security arrangement and review & reconciliation. No specific information about these areas is mentioned. The EP has not evaluated these documents. Therefore, the contention of the EP of having performed risk assessment procedure is factually incorrect. Further, the EP's statement that she changed her view about the company and issued the disclaimer of opinion on learning about the financial mess in the group after the

unfortunate death of VGS, is an admission that prior to the death of VGS, she relied on the explanation of the management and did not perform any audit procedure to identify, assess and respond to RoMM due to fraud. Surprisingly, even after knowing about financial mess in the company, she did not report this fraudulent diversion of funds in the 'Basis of disclaimer of opinion' section of her Independent Auditor's Report. With reference to her reply that diversion of funds can emerge only from an investigation and is not capable of being detected by a statutory auditor, as detailed and analyzed above, we find that the diversion of funds was evident from the Financial Statements and other information accessible to the EP. Accordingly, we find that the EP did not comply with SA 200, SA 240, SA 315 and SA 330.

- 46 In respect of noncompliance with section 143(12) of the Act relating to non-reporting of fraud to the Central government, the reply of the EP that no agency had termed the said transactions as fraudulent, is misplaced. The findings of an Auditor are not dependent on findings of any other agency and should be the outcome of the Auditor's professional skepticism which was totally lacking in this case. The EP failed to detect the fraud that was apparent and failed to report it to the Government of India thus violating section 143(12) of the Act. The EP has also violated CARO, as she reported that no fraud was noticed during the course of audit.
- 47 In respect of the EP's reply regarding 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, we note that the fraudulent diversion of funds was apparent from the Bank Statements and from the Financial Statements itself, and was in the knowledge of the EP. After the death of VGS (in July 2019) the fraud was clearly in the know of the EP, but she chose to remain silent. 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 and section 3 of PMLA. We find that the EP has failed to report this violation in the audit report, thus violating SA 250.
- 48 The Auditor should know, amongst other things, that gaining an understanding of the business purpose of such transactions and examination of the agreements, contracts, and other transaction-related documents is primary to any audit. There is no audit evidence to support a valid understanding of the business and the business purpose for huge borrowing and lending transactions. Even when there were circumstances warranting increased scrutiny and facts strongly suggesting fraud, magnified after the death of VGS, the EP failed to perform any additional auditing procedures. This indicates that the EP did not exercise the necessary professional skepticism to determine whether these transactions posed a risk of material misstatement due to fraud.
- 49 In view of above analysis, we find that this charge is proved that the EP has violated section 143(12) of the Act, CARO, SA 200, SA 240, SA 250, SA 315, SA 330 and failed to report violation of section 179(3) of the Act by MACEL.
- 50 We note that PCAOB⁹, the US regulator, 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*

⁹ PCAOB Release No. 105-2020-012 and PCAOB Release No. 105-2020-013 both dated 24.09.2020.

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, prohibiting Marcum, for a period of three years 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.

C.2 Failure to detect evergreening of loans through structuring circular transactions of funds

51 The EP was charged with failure to perform risk assessment procedures to identify and assess Risk of Material Misstatements due to fraud and failure to exercise professional skepticism while performing audit of related party transactions. Evergreening of loans through structured circular transactions of funds, was evident on analysis of cheques issued and received by MACEL in FY 2018-19 but debited and credited in FY 2019-20. Banks-wise details are given in subsequent paras.

Karnataka Bank

52 On 30.03.2019 MACEL issued six cheques for total amount of Rs 105.00 crores favoring CDGL. On 04.04.2019 the account received Rs 22.70 crores from MACEL’s own bank a/c in Yes Bank. This was followed by a series of circular transactions, on the same day, between MACEL and CDGL, starting with MACEL paying Rs 20 crores to CDGL, followed by CDGL paying the same amount to MACEL and so on for clearance of the above referred six cheques issued on 30.3.2019.

53 On 10.04.2019, MACEL received Rs 90 crores from CDGL which again started a series of payments on the same day in a circular manner for clearance of four cheques of total amount of Rs 350 crores issued to TDL on 31.03.2019 & eight cheques of total amount 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.....

54 On 10.05.2019 MACEL got Rs 10 crores from its own bank a/c with Corporation bank, which again started a series of sham circular payments on the same day for clearance of five cheques of total amount of Rs 50 crores issued to GVIL on 30.03.2019. For example, Rs 10 crores was paid by MACEL to GVIL, which then paid Rs 10 crores to MACEL, which then paid Rs 10 crores to GVIL and so on.....Further, in the bank statement there are 35 entries on date 10.05.2019, each for Rs 10 crores, for payment to GVIL as well as receipt from GVIL in a circular manner.

Corporation Bank

55 MACEL issued five cheques of Rs 25 crores each (total Rs 125 crores) in FY 2018-19 to CDTL, which were cleared on 10.04.2019 through a series of sham transactions in a circular manner with

the credit balance of Rs 25.07 crores only by rotating funds between MACEL and CDTL in five circular transactions of Rs 25 crores each.

- 56 On 26.04.2019, MACEL received Rs 20 crores from CDGL which started a series of sham payments on the same day for clearance of six cheques totaling Rs 131.20 crores by circulating the funds amongst MACEL, Gonibedu Coffee Estates Pvt Ltd ('Gonibedu' hereafter) and Kumargode Estates Ltd ('Kumargode' hereafter). Gonibedu and Kumargode are related parties of MACEL.
- 57 On 03.05.2019, with the credit balance of Rs 40.11 crores only, 10 cheques totaling Rs 333.88 crores (which were issued on 31-03-2019) were cleared through similar transactions in a circular manner by rotating funds among MACEL, TDL, TRRDPL and Gonibedu.
- 58 On 18.05.2019, MACEL paid Rs 50 crores to TRRDPL starting a series of sham transactions as thereafter TRRDPL paid Rs 50 crores to MACEL, which then paid Rs 50 crores to TRRDPL, which then paid Rs 50 crores to MACEL, which then paid Rs 40.99 crores to TRRDPL, which then paid Rs 40.99 crores to MACEL. In the Bank Reconciliation Statements (BRS), these cheques were shown as received but not credited in bank as on 31.03.2019.

IndusInd Bank

- 59 On 02.04.2019, MACEL received Rs 32 crores from CDGL through six RTGS transactions, which was then used to clear on the same day, one by one in circular manner, the five cheques of total amount of Rs 25 crores issued on 30.03.2019. For example, CDGL paid Rs 7 crores to MACEL, which then paid Rs 6.70 crores to CDGL, which then paid Rs 6 crores to MACEL, which then paid Rs 5 crores to CDGL and so on.....

Yes Bank

- 60 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 of total amount of 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. After completing these transactions, Rs 22.70 crores was transferred to bank account with Karnataka Bank referred to above.
- 61 The SCN noted that the clearance of a large quantum of loans through structured circulation of smaller amounts of funds had resulted in evergreening of loans within the group, which was an indicator of the severe financial crisis in MACEL and fraudulent intentions of MACEL to misstate the Financial Statements. One of the important substantive audit procedures, the SCN noted, is to examine the Bank Statements and the evergreening of loans mentioned above showed that the EP did not exercise due diligence while performing audit of Bank Statements.
- 62 The unusual feature of evergreening of loans through structured circular transactions of funds was an indication of suspected fraudulent intentions of the MACEL. The SCN noted that there is no evidence in the Audit File that the EP had performed any procedure to identify and respond to RoMM in light of this evergreening of loans despite the fact that it was evident from the bank statements of MACEL. She also did not ask any question to Those Charged With Governance (TCWG) and Management about these unusual transactions. Accordingly, the EP was charged for not having performed the audit with professional judgement and professional skepticism and thus not complying with SA 200, SA 240 and SA 315.

63 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, transactions related to evergreening of loans were mere book entries without adequate funds available with any company, done with the ulterior motive to misstate the financial statements. The EP did not report these fictitious accounting entries and thus violated section 143(1) of the Act.

Reply of the EP

64 The EP has denied this charge stating that these transactions were a desperate attempt of Management in FY 2019-20 to honor the cheques issued in FY 2018-19, as planned funds did not come therefore management arranged funds from Associates. The transactions did not achieve any wrongful purpose. She further mentioned that the method of fund management adopted by MACEL did not form any basis to allege professional misconduct against her. While drawing attention to para 10 to 15 of SA 700 'Forming an Opinion and Reporting on Financial Statements', the EP contended that there is no mandatory responsibility on the Auditor to examine the manner in which funds were managed by the company to clear the cheques issued. This is not within the scope of statutory auditor in normal course of audit unless there is a reason to suspect fraudulent intent, which she did not find.

65 While drawing attention to para 5 and 13 of SA 240 'Auditor's responsibility relating to Fraud in an Audit of Financial Statements', relating to inherent limitation of an audit and context of professional skepticism, the EP contended that there was no reason to believe wrongful intentions on the part of the management as they gained nothing through circular transactions and rotation of funds and these did not constitute material misstatements. The EP further contended that disclaimer of opinion was issued on Internal Financial Control System, which naturally included these circular transactions.

66 While drawing attention to definition of 'Material Misstatements', the EP contended that she has to examine the elements in the Financial Statements for the accuracy of amounts, correctness of time of recognition, completeness of transactions, classification in appropriate group and presentation & disclosures as per financial reporting framework. This was achieved through a detailed process of verification, validation, examination, discussion and inspections. However, it is not possible to record the whole process in audit working paper and also not required to be recorded as per SA 230- 'Audit Documentation'. The EP further stated that documents of risk assessment procedures performed are available at page 24, 180 and 181 of the Audit File forming part of annexure to SCN and the process of examination by her did not result in identification of risk of any material misstatement.

67 Regarding bank statements, the EP contended that she had verified books of accounts with bank statements to ascertain that bank transactions were duly recorded in the books of accounts, and final position of assets and liabilities was correctly presented in the balance sheet. She stated that there is no error in accounting, hence no misstatements and that raising of money from associate entities to clear off cheques already issued was not illegal and such transactions were not qualified to be reported as fraudulent transactions as per SA 240.

68 The EP further contended that the Standards of Auditing are not reference material to decide on charges of professional misconduct against an Auditor; on the contrary these are for guidance to an

Auditor to act professionally. There is no provision in law to hold an Auditor guilty of professional misconduct because the Auditor has erred in her judgement in application of provisions in SA 240 or SA 200.

- 69 In respect of the charge relating to violation of section 143(1) of the Act, the EP contended that these were actual bank transactions represented by cash flows, accordingly there was neither any material misstatements nor any effect prejudicial to interest of the company.

Analysis of reply

- 70 Having considered the reply, we note that the fact of evergreening of loans evident from banks statements has not been refuted by the EP. Her line of defense is that 'planned funds' did not come hence funds were arranged from Associates. There is no record in the Financial Statements and the Audit File about any 'Planned Funds' as contended by the EP. We note that circular transactions did not result in net cash flow (either inflow or outflow) to MACEL. Cheques were issued, received and recorded in books of accounts in FY 2018-19. Subsequently, in FY 2019-20, these cheques were cleared through circulation of funds among group companies and the incremental accounting impact of such circulation of funds was recorded in books of accounts in FY 2019-20. We find that this resulted in misstatements in financial statements of both the year i.e., FY 2018-19 and FY 2019-20. Since there was no 'Planned Funds' for clearance of those cheques, it can be reasonably inferred that it was a preplanned scheme of promoters to misstate financial statements to deceive stakeholders.
- 71 In respect of the contention of the EP that she is not responsible to examine the manner of fund management by MACEL, we find that preplanned scheme of promoters to misstate financial statements through circulation/ rotation of funds could be easily detected from the bank statements had the EP shown the slightest alertness during the course of Audit, particularly when she was aware of the financial mess committed by VGS. Therefore, the examination of fund management was well within the scope of the EP.
- 72 The definition of 'Misstatement' given in SA 200 inter alia describes that 'Misstatement can arise from error or fraud'. As already discussed, evergreening of loans through circulation of funds was done to fraudulently misstate financial statements. We find that the arguments of the EP that rotation of funds did not result in any misstatement in the Financial Statements, shows complete lack of professional skepticism in the EP. While the fraud was apparent earlier, it got established after the financial mess was unveiled post the death of VGS in the first half of the financial year. Despite this, the warranted audit procedures were not performed.
- 73 Further, we have already examined that the contention of the EP of having performed risk assessment procedure is factually incorrect. With respect to the contention of the EP that all bank transactions were correctly recorded in the books of account and that there is no accounting error, we find that she has not been charged for the same in the SCN. The EP's contention that SAs are not reference material for deciding misconduct of an Auditor, is erroneous as the Auditor is duty bound to comply with SAs in terms of section 143(9) and section 143(10) of the Act¹⁰.

¹⁰ 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.

74 Regarding violation of section 143(1) of the Act in respect of circulation of funds, we notice that circulation of funds was done by MACEL intentionally to misstate the Financial Statements and it did not result in any net cash flow and remained book entries only, resulting in fictitious accounting entries as per section 143(1) of the Act. Accordingly, this charge is proved that the EP violated SA 200, SA 240, SA 315 and section 143(1) of the Act.

C.3 Lapses in audit of inappropriate recognition of Finance Cost of Rs 40.47 crores

75 The EP 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 40.46 crores as corresponding borrowings were not used for business activity of MACEL. The EP was also charged with violation of section 143(2) and 143(3)(e) of the Act, as finance cost was an extraordinary expense but shown as ordinary finance cost resulting in violation of Division I of Schedule III of the Act and Accounting Standards ('AS' hereafter) 5, Net profit or loss for the period, prior period items and changes in accounting policies.

76 The SCN noted that MACEL had recognized finance cost of Rs 40.46 crores in FY 2019-20, which was 91.89% of total expenses of Rs 44.04 crores. Total bank borrowings of the company were Rs 160.02 crores on 31.03.2020 and Rs 272.32 crores on 31-03-2019. Examination of the Financial Statements shows that the borrowed money was not used for the business activity of the company, but diverted to related parties. Out of the total assets of Rs 4,218.09 crores, approx. 99% (Rs 4,176.67 crores) was given as loans & advances, leaving assets of only Rs 41.42 crores to be used for business activities of MACEL. Though the finance cost of borrowed fund was recognized, the interest income on loans and advances given to promoters and other related parties was not recovered, resulting in material and pervasive misstatement in the Profit and Loss Statement by a large proportion of finance cost.

77 As per SA 315, the EP 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 required the EP to design and perform analytical procedures near the end of the audit that would have assisted her in forming an overall conclusion whether the Financial Statements are consistent with her understanding of MACEL. As a prudent Auditor, she was required to critically analyze the finance cost & bank borrowings with the assets used for business activity of MACEL. Analysis in previous para and application of Professional Skepticism as provided in SA 200 should have aroused suspicion in her mind. As per para 32(c) of SA 240, she was required to evaluate whether there is any fraud in recognition of finance cost, being unusual in nature. Examination of the Audit File, according to the SCN, shows that she did not perform any audit procedure and also did not ask any question to TCWG and Management, and thus violated SA 200, SA 240, SA 315 and SA 520.

78 Further, as per para 4.2 of AS 5 'Net Profit or Loss for the Period, Prior Period Items and Prior Period Items and changes in accounting policies', 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. As per Division I of Schedule III of the Act and para 8 of AS 5, extraordinary items should be disclosed in the statement of profit and loss as a part of net profit or loss for the period. The nature and amount of each extraordinary item should be separately disclosed in the statement of profit and loss 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 statement of profit and loss in the manner described

above. Examination of the Financial Statement shows that MACEL did not disclose finance cost as extraordinary expense but as ordinary finance cost, thus violated 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. The SCN charged that the EP has violated section 143(2) & 143(3)(e) of the Act as she 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. .

Reply of the EP

- 79 While denying the charge the EP stated that interest expenses incurred were neither in violation of any law nor inconsistent with accounting principles in force. MACEL paid interest on borrowed amount whereas there was no contractual obligation to pay interest by the entities to whom loans/advances were given by MACEL. In respect of not charging interest on the loans/advances given by MACEL, the EP contended that there was no authority with the EP to dispute the Management action relating to charging of interest or not. She contended that interest expense was incurred by MACEL and duly reflected in the Profit and Loss Statement, hence cannot constitute a misstatement. The EP stated that proper disclosure about advances given to persons covered under section 189 of the Act has been given in CARO report, to discharge her responsibility as per section 143(1)(a) of the Act.
- 80 The EP has contended that based on the information and evidence collected by her, she was not in a position to form a view that there was any fraud in recognition of interest. She replied that reference to para 32(c) of SA 240 is misplaced. According to her, para 31 & 32 of SA 240 are in the context of overriding controls by management to perpetuate fraud. In MACEL, there was no override of controls. Management of MACEL were no other than shareholders, hence she could not see it as a fraud. The EP further contended that she had given disclaimer of opinion and disclosed the interest free nature of advances made, therefore she had no other obligation in this regard.
- 81 While drawing attention to para 9 and 10 of AS 5, the EP contended that going by the spirit of principles in AS 5, proposition of NFRA that finance cost was an extra-ordinary item is denied and there was no violation of AS 5 and Schedule III of the Act. She further replied that it is incorrect to say that she had reported that financial statements comply with Accounting Standards specified under section 133 of the Act, whereas in the Audit Report she had expressed her inability to comment whether the financial statements complied with Accounting Standards specified under section 133 of the Act.

Analysis of reply

- 82 MACEL is a small company having Revenue from Operation of Rs 3.27 crores only. Its total business assets are Rs 41.42 crores only in the form of Tangible assets, Inventories, Cash and Cash equivalent and Other Current Assets. Compared to this, its Balance Sheet size of Rs 4218.09 crores is disproportionately large, mainly on account of Rs 4176.67 crores loans given to related parties, with whom MACEL did not have any business relations. The loans given to the related parties were without any business rationale and clearly beyond the normal course of business.
- 83 MACEL's total borrowings were Rs 4479.79 crores, of which a major part was from related parties. Since the assets used for the business activities of MACEL were only Rs 41.42 crores, it is evident that the remaining borrowings of Rs 4438.37 crores (Rs 4479.79 crores - Rs 41.42 crores) were

diverted to related parties. Therefore, the diversion of funds was clearly visible from the Balance Sheet signed by the EP.

- 84 MACEL recognised huge interest expenses of Rs 40.47 crores, whereas interest income of Rs 0.15 crores only was recognised in its Profit and Loss Statement signed by the EP. A combined reading of the Balance Sheet and the Profit & Loss Statement clearly shows that the proceeds of interest-bearing loans were diverted to related parties at no or nominal interest. Therefore, it is clear that Related Party Transactions were not at 'Arm's Length'. Further, this resulted in recognition of loss of Rs 40.62 crores in the Profit & Loss Statement for FY 2019-20. Had the interest been recovered from the related parties, which used these funds, the loss of MACEL would have been minuscule. A similar trend is visible in FY 2017-18 and FY 2018-19. This practice has eroded the entire net worth of the company, which was a negative Rs 264.32 crores on 31.03.2020.
- 85 The EP has replied that interest expense was incurred and duly accounted for. She could not give any reply why such interest expense should be ultimately borne by MACEL, when the borrowed money was not used by MACEL and passed on to other related entities. The EP failed to question why the interest on such borrowed money should become expenses of MACEL, unless the corresponding interest income on advances made to related parties is also recognised as interest income of MACEL. In that context, we find that interest expense of Rs 40.47 crores has resulted in misstatement in the Profit and Loss Statement of MACEL.
- 86 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 EP was duty bound as per SA 240 to evaluate such an 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 EP of her responsibility to report misstatement in Profit and Loss Statement, which is required to be reported in the Independent Auditor's Report as per SA 700. Section 143 of the Act prescribes powers and duties of Auditors. Subsection (1)(a) of the said section provides that an auditor has right to inquire "*whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are prejudicial to the interest of the company or its members*". The EP has reported at para (iii) of CARO report that "*The company has not granted any loan, secured or unsecured to companies, firms, Limited Liability Partnerships or any other parties covered in the register maintained under section 189 of the Companies Act, 2013. However, the company has granted advances to various companies and other parties covered in the register maintained under section 189 of the companies Act 2013. According to the information and explanation provided to us, these advances are interest free and with no fixed repayment tenure and are repayable on demand*". It is clear from above that the EP did not disclose whether such loans (termed as advances) were secured or not. Despite being fully aware of their existence, she failed to evaluate whether such loans were prejudicial to the interest of the company or its members. Therefore, her claim of having discharged her responsibility under section 143(1)(a) of the Act, is factually incorrect.
- 87 With respect to the management override of controls, the EP has argued that there was no override of control as the Management of MACEL were no other than shareholders themselves. It is obvious that involvement of shareholders in the day-to-day management of MACEL was a proof of override of controls. In this case VGS, Chairman of CDEL (a listed company) transferred huge funds from subsidiary companies of CDEL to MACEL and further from MACEL to his own personal accounts, his family members' personal accounts and to other entities owned by them, by using pre-signed

blank cheques. This is a classic example of override of controls and the reply shows that the EP has poor understanding of the meaning of ‘Override of Controls’.

- 88 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 the nature of transaction determines whether a transaction is distinct from ordinary activity of the enterprise. In this case, the interest expense did not arise in the course of ordinary activity of MACEL but due to the borrowings not meant for MACEL’s business but to siphon off funds by the promoters using MACEL as a conduit; therefore this is a rare occasion and such interest expense was to be classified as extraordinary expense.
- 89 Division I of Schedule III of the Act prescribes the format of the Profit and Loss Statement, which has been followed by MACEL, and includes a line item ‘Extraordinary Items’. MACEL has shown NIL amount against this line item. Interest cost incurred by MACEL on Borrowings from Related Parties which were not meant for the ordinary business activities of MACEL is no doubt an extraordinary item within the meaning of para 9 of AS 5. However, by not classifying interest cost of Rs 40.47 crores as extraordinary item in the Profit and Loss Statement, MACEL violated Division I of Schedule III of the Act and AS 5, and the EP failed to report this.
- 90 With reference to the response of the EP regarding disclaimer on compliance with accounting standards specified under section 133 of the Act, we have perused the audit report and find that she had expressed her inability to comment whether the financial statements complied with accounting standards specified under section 133 of the Act. This reply is partially correct. However, we perused this disclaimer at para (d) of the Audit Report which states “*We are unable to comment whether the aforesaid financial statements comply with the accounting standards specified under section 133 of the Act, read with rule 7 of the Companies (Accounts) Rules, 2014 because of the significance of the matters described in Basis for Disclaimer of Opinion section above*”. As can be seen from the wording of the disclaimer of opinion, it is only related to compliance with ASs in respect of subject matter of disclaimer of opinion i.e., recoverability of Loans to Related Parties. It does not relate to non-compliance with ASs in respect of other areas such as the instant case of failure to classify the interest cost incurred on extraordinary borrowings, as the extraordinary expense. Thus MACEL did not comply with AS 5 and the EP failed to identify and report this material misstatement. In view of above analysis, we find that the EP has violated section 143(2) and 143(3)(e) of the Act.

C.4 Lapses in audit relating to misstatement of Rs 1938.87 crores in the Cash Flow Statement

- 91 The EP was charged with failure to report material misstatement of Rs 1938.87 crores in Cash Flow Statement resulting in violation of section 143(2) & 143(3)(e) of the Act. According to the SCN, 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 decrease in short term borrowings of Rs 1,877.56 crores as negative Cash Flow from Operating Activities resulting in understatement of Cash Flow from Operating Activities and overstatement of Cash Flow from Financing Activities by Rs 1,877.56 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 decrease in short term loans & advances made (assets) of Rs 61.31 crores as Cash Flow from Operating Activity resulting in overstatement of Cash

Flow from Operating Activity and understatement of Cash Flow from Investing activity by Rs 61.31 crores.

Reply of the EP

- 92 The EP 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 1,877.56 crores, Rs 109.03 crores represented repayment of bank borrowings and deserved to be included under 'Cash Flow from Financing Activities', while the remaining amount represented changes to operating assets/liabilities like advances received and advances given, and was therefore correctly classified under 'Cash Flow from Operating Activities'. The EP further stated that the admitted mistake may be pardoned as an inadvertent presentation error because it is not material.
- 93 Regarding the charge relating to loans/advances made to third parties, the EP denied the charge stating that advances were given for furtherance of their business objectives associated with several coffee estates managed by the associate entities and so these advances related to operations. She contended that they were not loans. The EP 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 EP 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

- 94 Para 3 & 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*".
- 95 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.

- 96 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 response, the EP has admitted wrong presentation of cash flow from short-term borrowing of Rs 109.03 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.
- 97 For the remaining amount of Rs 1,768.53 crores (Rs 1877.56 crores - Rs 109.03 crores), the EP argued that these represented changes to operating assets/liabilities like advances received and advances given, and was therefore correctly classified under 'Cash Flow from Operating Activities'. It is noticed that this borrowed fund of Rs 1,768.53 crores was 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. Therefore, this Cash Flow does not qualify as Cash Flow from Operating Activities of MACEL. This Cash Flow was on account of short term borrowings, therefore was required to be classified as Cash Flow from Financing activities as defined in AS 3.
- 98 Similarly, in respect of Cash Flow from refund of loans/advances of Rs 61.31 crores made to third parties, it is observed that these were not included in cash equivalent, therefore these were Investment Activities as per its definition quoted above. Further, MACEL did not have any operational/business relations with other coffee estates managed by associate entities, thus this amount was not used for principal revenue-producing activities of MACEL.
- 99 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 and excess amount, if any, to be refunded at the time of final settlement after delivery of goods or service. Whereas 'Loan' is a money given by one person to another with clear understanding that recipient of money will return the money, to the lender after certain period of time normally with interest. In this case, money originally given by MACEL to other entities was not for supply of any goods or services to MACEL, therefore such transactions cannot be treated as Cash Flow from principal revenue-producing activities of MACEL. Accordingly, this Cash Flow of Rs 61.31 crores does not qualify as Cash Flow from Operating Activities of MACEL.
- 100 Para 12 to 17 of AS 1 relates 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 states '*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.
- 101 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, thus violated section 129(5) of the Act. The EP did not report material misstatement of Rs 1938.87 crores in the Cash Flow Statements in the Disclaimer of Opinion section of her Independent Auditor's Report. Therefore, we find that the EP's reply is not satisfactory and this charge stands proved that the EP 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

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

Reply of the EP

- 104** While admitting that the Audit File does not contain any noting regarding evaluation of whether guarantees given were against the interest of the company, the EP replied 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 on the part of the EP, for which no charge of professional misconduct is tenable.
- 105** While admitting that non-funded transactions were required to be included in Related Party Disclosures, the EP replied that she had expressed her inability to form affirmative opinion on the points of compliance with Accounting Standards. Therefore, she is professionally not liable for the omission as the same has been reported negatively in the Audit Report.

Analysis of reply

- 106** 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. Instead of evaluating this risk, the EP 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.

- 107 Section 143(2) of the Act casts reporting obligation on 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.*” (Emphasis supplied).
- 108 We observe that The Company’s (Audit Report) Order 2016 (CARO) is an order issued under section 143(11) of the Act. 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 the truthfulness and fairness of the Financial Statements. Accordingly, before making a conclusion, the EP was duty bound to evaluate whether these were not prejudicial to the interest of the company. We note from the reply that the EP wants to shirk her responsibility cast under section 143(2) of the Act.
- 109 We further note that the EP has admitted that ‘Related Party Disclosures’ (‘RPD’ hereafter) were deficient as it did not include the above-mentioned non- funded transactions of Rs 130 crores but wants to shirk her responsibilities citing that the same had been reported negatively in the Audit Report. We perused the Audit Report which states “*We are unable to comment whether the aforesaid financial statements comply with the accounting standards specified under section 133 of the Act, read with rule 7 of the Companies (Accounts) Rules, 2014 because of the significance of the matters described in Basis for Disclaimer of Opinion section above.*” On perusal of the Basis for Disclaimer of Opinion section in the Audit Report we find that there is no mention about non-disclosure of Related Party Disclosures relating to these non-funded transactions of Rs 130 crores. Therefore, the EP’s reply is factually incorrect and we find that the charge that the EP has violated section 143(2) and 143(3)(e) of the Act, is proved.

C.6 Lapses in making audit conclusions and forming Audit Opinion (consolidated misstatements of point no (C.1) to (C.5) above, Rs 10,724.38 crores)

- 110 The SCN charged the EP with not considering material misstatement of Rs 10,724.38 crores¹¹, while making audit conclusions and forming audit opinion, thus violating SA 700 ‘Forming an opinion and reporting on financial statements’, which requires the Auditor to conclude that 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.
- 111 In order to arrive at 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, which is basic audit procedure for forming an opinion.

¹¹ Break up of Rs 10,724.38 crores is loans & advances (liabilities)-Rs 4,438.37 crores, loans & advances (assets)- Rs 4,176.67 crores, incorrect recognition of finance cost-Rs 40.47 crores, overstatement of cash flow from operating activities- Rs 1,938.87 crores and misstatement in issuance of corporate guarantee and creation of charge on the assets of the company-Rs 130 crores.

112 Misstatements in the Financial Statements not only represented a 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 evergreening of loans indicated that the 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 the users of the Financial Statements. While the EP had given a disclaimer of opinion on the basis of absence of evidence for recoverability of amount due from debtors, she did not consider the misstatements of Rs 10,724.38 crores and evergreening of loans while making audit conclusion and forming audit opinion. Accordingly, the SCN charged that the EP had violated SA 320 and SA 700.

Reply of the EP

113 The EP has denied the charge and stated that amount shown as misstatement in SCN does not meet the criterion of misstatements as defined in para 4(a) of SA 450¹². According to the EP, 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 the SCN has not determined misstatements in this manner, therefore determination of misstatements is flawed.

114 The EP further replied that there is no error in amounts, presentation, classification and disclosures in respect of assets, liabilities and interest cost. While responding to the charge relating to misstatement in cash flow statement, she admitted to a misstatement of Rs 109.03 crores but argued that it is not material going by the size of balance sheet and cash flow statement. In respect of misstatement relating to non-funded related party transactions, the EP replied that she had correctly reported that the company had not complied with accounting standards.

115 While drawing attention to para 2 of SA 320 relating to description of the term 'material', the EP contended that admitted misstatement of cash flow statement (Rs 109.03 crores) is not the 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 the misstatement in RPT (Rs 130 crores) had no significant impact because these were non-funded obligations and only contingent in nature; that she is not professionally liable as she has given negative opinion on compliance of accounting standards; and that these two omissions would not have constituted material misstatement going by the principles of SA 320.

116 The EP finally replied that the alleged material misstatements shown in the SCN, are not material misstatements at all to be reported. However, she had identified the essential misstatement attributed to suspected irrecoverable 'advances granted' of Rs 3,401 crores in view of the fact that MACEL was unable to recover those advances or liquidate its liabilities, although those advances were claimed to be payable on demand. The EP contended that she had issued disclaimer of audit opinion as per SA 705 and it matters least, whether any other possible material misstatement was covered in it or not, because the audit report does not provide absolute assurance, but is expected to provide reasonable assurance.

¹² SA 450, Evaluation of Misstatements identified during the Audit.

Analysis of reply

- 117 The import of the EP's reply is that all transactions have been recorded & accounted for and as such there are no misstatements in the Financial Statements. It would be important to look at the term misstatement, as defined 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"*.
- 118 It has already been proved in the foregoing discussion that the 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 has also been partially admitted by the EP) and misstatement in issuance of corporate guarantee has also been admitted by the EP. These misstatements were clearly the result of fraud or error and have been so identified in the SCN. The EP's reply indicates her lack of due diligence and gross negligence in making audit conclusions and forming an Audit Opinion.
- 119 The EP has further contended that admitted misstatements of Rs 239.03 crores are not material as these could not reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements. We note that the EP did not determine the materiality level while conducting the Audit, which is non-compliance with SA 320. We further observe that MACEL had revenue of Rs 3.42 crores only, a negative net worth of Rs 264.32 crores and assets of Rs 41.42 only which were used for business activity of MACEL, as the rest of the assets were in the form of loans/advances made to related parties. Keeping this in view, the misstatement of Rs 10,724.38 crores in financial statements of MACEL were more than 250 times of its assets and therefore significantly material misstatements. It is baffling that the EP did not find materiality in these staggering figures. In the presence of such pervasive misstatements, the Financial Statements of MACEL for FY 2019-20 did not give true and fair view of its Financial Position as on 31.03.2020, and the Financial Performance and Cash Flow for the FY 2019-20. Despite that, the EP did not report these pervasive misstatements in the Disclaimer of Opinion Section of the Independent Auditor's Report.
- 120 In respect of the EP's contention that she had given disclaimer of opinion for recoverability of advances of Rs 3,401 crores and that it matters least whether any other possible material misstatements were covered in the disclaimer, because audit report does not provide absolute but reasonable assurance, we would like to repeat, as already examined earlier in this Order, that as per para 27 of SA 705, the Auditor is required to report all matters having material effect on the financial statements, in the Basis of Disclaimer section of the audit report. In this case, we find that the EP has not reported material misstatement of Rs 10,724.38 crores in the audit report, and thus violated SA 700 & SA 320. Therefore, this charge is proved.

D. OTHER NON-COMPLIANCES WITH LAWS AND STANDARDS.

In addition to the lapses detailed in Section- C of this 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 (IFC)
- b) Violation of Section 143(2) of the Companies Act 2013
- c) Failure to ensure compliance with 134(1) of the Companies Act 2013
- d) Failure to comply with SA 570, Going Concern
- e) Failure to comply with SA 505, External Confirmations
- f) Failure to comply with Standard on Quality Control and SA 230, Audit Documentation
- g) Failure to comply with SA 580, Written Representations

Analysis and Findings

- 121** The EP has denied any wrongdoings and professional misconduct in all the charges mentioned above.
- 122** In respect of the EP's failure to understand the control environment, identify and report absence of adequate and effective Internal Financial Controls and identify potential RoMM due to misuse of bank cheques by a person functioning as de facto management of MACEL, the EP 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; that granting of advances was the result of decisions taken by VGS, who concealed crucial facts from all others, and that the EP had no opportunity to develop any doubt or apprehension about the transactions of advances granted. She further stated that these advances were granted before the death of VGS and there were no such transactions after his death during 8 months of FY 2019-20. The EP further replied that she had issued report for the whole of FY 2019-20 and that recoverability of advance was mentioned in the basis of disclaimer of opinion.
- 123** We find that the EP 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 EP 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 company closely held by promoters of the listed entity. Further, it is alarming to note that the EP turned a blind eye to the accounting jugglery in MACEL by VGS, an individual who was neither a shareholder nor a director nor an employee. The accounting jugglery was to misrepresent the financial affairs of the company and involved massive amounts. We observe that the EP did not report about the absence of internal financial control evident in the pre-signing of blank cheques that were used for diversion of funds and evergreening of loans. She has only reported about her assessment of the recoverability and requirement or otherwise of provision in respect of amount of Rs.3401.66 crores due from VGS, his family members and entities owned/controlled by them, in

her disclaimer of opinion in the Independent Auditor's Report. We find that the EP has not complied with section 143 (3) (i) of the Act.

- 124** With reference to non-compliance with section 143(2) of the Act, the EP admitted that the presentation of short term borrowing payable on demand and advances recoverable on demand were erroneously included under long term borrowings and long term advances respectively. However, she argued that this error cannot be termed as misleading to a reader of Financial Statements because the nature and substance of line items are very clear from presentation. Terming this a clerical oversight without any intent of misstatement, she requested to be pardoned, terming this as an error in presentation and as inconsequential. Further, she denied the allegation regarding non-disclosure of related parties, stating that a separate disclosure on 'Related Party Transactions' (RPT) had been made in note no.16 of financial statements. Further, the EP stated that she had not given any assurance in her audit report that MACEL had complied with accounting standards.
- 125** We observe that 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 EP needs to exercise due professional care, which we find was absent.
- 126** The EP 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. We note that as per section 134(1) of the Act, approval of the Financial Statements by the Board and its signing by the persons authorized by the Board are prerequisites before an auditor makes a report on such approved & signed financial statements. The EP should have obtained a certified copy of the Board resolution approving the Financial Statements and authorizing the Directors to sign the Financial Statements and should have kept the same in the Audit File before its assembly. The EP did not do the same. Thus, this charge is proved.
- 127** While denying the charge in respect of SA 570- Going Concern, the EP contended that she had given detailed disclosure in the Audit Report about the material uncertainty related to going concern assumption followed by the company. In para (f) of the Audit Report, it is mentioned that going concern matter may have adverse effect on the functioning of the company. The EP further stated that disclaimer of audit opinion issued by her proved that pervasive misstatement is possible in the Financial Statements. There cannot be any clearer message from an auditor about the state of affairs of the company.
- 128** We observe that the EP has not responded to the moot question as to how the 'Going Concern' status was evaluated on one year old data. She evaluated the going concern status of MACEL on 31-03-2020 by evaluating the financial indicators as on 31-03-2019. Accordingly, it is clear that she did not evaluate the going concern status of MACEL on 31-03-2020. As such the Independent Auditor's Report given by her on the going concern status of MACEL as on 31-03-2020 was devoid of relevant basis. Further, no reply is given about the evaluation of the 'Business Plan', as mentioned by MACEL in its disclosure in the Financial Statements. MACEL did not make clear disclosure in the Financial Statements relating to its going concern status with respect to realization of its assets and discharge of liabilities in the normal course of business. The EP did not consider incompleteness of disclosures made by MACEL in this regard. Instead, she has given a general reply that disclosure

given by MACEL was appropriate. The absence of a clear disclosure by MACEL on its going concern status, should have been considered by the EP while forming an audit opinion. However, EP failed to do so. Thus, this charge is proved.

- 129 In respect of violation of SA 505- 'External Confirmations', the EP 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.
- 130 While agreeing with the EP'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 that audit evidence obtained directly by the auditor is more reliable than that obtained indirectly and so on. It is astonishing to read the EP's averment regarding superiority of audit evidence in the form of bank statements versus bank balance confirmations. The EP has failed to learn from the recent episodes of catastrophic accounting frauds which remained undetected due to deficient audit procedures lack of due regard for independent audit confirmations¹³.
- 131 In respect of non-compliance with SA 230 'Audit Documentation', the EP has replied that the delay in submission of documents to NFRA was not attributed to reasons surmised in the SCN and that NFRA should look at the conduct of auditor more objectively rather than creating allegations on surmises.
- 132 The EP's failure to ensure completeness of the Audit File before submission to NFRA, in respect of an audit completed twenty months ago, is nothing but lack of professional due care and gross negligence and accordingly we hold that the EP is responsible for non-compliance with SA 230.
- 133 In respect of non-compliance with SA 580 'Written Representations', the EP denied the charge referring to para 3 of SA 580 and stated that written representations are not conclusive proof of appropriate audit evidences and where an auditor has obtained appropriate audit evidence, obtaining a written representation is not required. She further replied that taking the spirit of SA 580, she had obtained written representation which are available at page no 32-34 of the Audit File forming part of annexure to SCN.
- 134 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 as per para 9 of SA 580¹⁴. It is found that the EP has not obtained any of the written representations as mandated by the Standard. On the contrary, the work papers relied upon by the EP relate only to the outdated (pertaining to an earlier year) audit work papers on going concern assessment and a letter from an unnamed director clarifying certain queries raised by the EP.
- 135 In view of this analysis, the charges that the EP has violated section 143(2) & 143(3)(i) of the Act, SQC 1, SA 230, SA 505, SA 570, SA 580 and failed to ensure whether MACEL had complied with

¹³ E.g., Satyam Computers Limited (2008) and Wirecard, Germany

¹⁴ Para 9 of SA 580 provides that the auditor shall request management to provide a written representation that it has fulfilled its responsibility for the preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation, as set out in the terms of the audit engagement.

section 134(1) of the Act, are proved. 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 EP.

136 We note that failures to perform audit procedures and exercise professional skepticism in Related Party 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, PCAOB¹⁵ 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.

E. OMISSIONS AND COMMISSIONS BY THE AUDIT FIRM

137 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.

138 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.

139 As part of the Audit File, the Audit Firm submitted a single page document 'Quality Control Policy' which appears to have been prepared for completing formality to show compliance with SQC 1.

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

141 While replying to individual charges, the EP denied all the articles of charges. We have already examined the pointwise replies 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 above.

¹⁵ PCAOB Release No. 105-2021-020 dated 14.12.2021.

F. ARTICLES OF CHARGES OF PROFESSIONAL MISCONDUCT BY THE AUDITOR

142 While denying all the articles of charges, the EP replied that she had issued disclaimer of audit opinion and had not given any opinion on compliance with the Accounting Standards; therefore, this is not a fit case for invoking section 132(4) of the Act. We have already examined the pointwise reply and found that all charges are proved except the charge relating to constitution of the Audit Committee.

143 As discussed, the EP has made a series of serious departures from the Standards and the Law, in conduct of the Audit of MACEL for FY 2019-20. Based on above discussion, it is proved that the EP was grossly negligent in her professional duties as she failed to comply with all the requirements of SA 705 i.e., she reported only one item as basis for disclaimer of audit opinion on the Financial Statements whereas there were many other areas such as diversion of funds, evergreening of loans which were also required to be reported in the Independent Auditor's Report. Further, she also committed many other serious lapses during performance of audit. Based on the foregoing discussion and analysis, we conclude that the EP 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, as detailed below:

- i. The EP 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 she is concerned with that financial statement in a professional capacity".
This charge is proved as the EP failed to disclose in the Audit Report the material non-compliances the Company made as explained in Chapter C and D (a)(b)(c) above.
- ii. The EP 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 EP failed to disclose in the Audit Report the material misstatements made by the Company as explained in Chapter C and D (a)(b)(c) above.
- iii. The EP 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 Chapter C and D above.
- iv. The EP 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 EP 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 Chapter C and D above.

- v. The EP 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 EP failed to conduct the audit in accordance with the SAs as explained in Chapter C and D above.

G. PENALTY AND SANCTIONS

144 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.

145 This order has detailed out all the lapses in Audit and the non-compliances with the Standards on Auditing made by the EP. The constant refrain of the EP throughout her reply has been that she became aware of the possible financial mismanagement only after the death of VGS and the contents of the letter he left behind. Consequent to that, she has relied on the Disclaimer of Opinion indicating non recoverability of advances made by MACEL. The death of VGS happened in July 2019 and the EP had sufficient time to evaluate all the parameters spelt out in this Order where the Standards have not been adhered to. Specially in the backdrop of the letter left behind by VGS, a diligent skeptical auditor should have evaluated every aspect of the accounts. The EP has been grossly negligent, to the extent of being almost blind to ignore a virtual takeover of the systems and controls by a person (VGS) who was neither a shareholder, nor a director nor an employee of MACEL. The Standards on Auditing do not free an Auditor from reporting all other misstatements once a Disclaimer on a particular aspect is given. The EP has failed in her statutory duty and has tried to hide behind one Disclaimer of opinion, which in itself was incomplete as she did not cover all aspects of infraction of the Laws and the Standards. All of this weighs heavily on our mind while determining the quantum of penalty.

146 The EP was required to ensure compliance with SAs 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 EP establish her professional misconduct. Despite being a qualified professional, the EP has not adhered to the Standards and has thus not discharged the duty cast upon her.

147 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) debarring 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.

148 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 2019-20 was Rs [REDACTED] and total professional fees received the Audit Firm during FY 2019-20 was Rs [REDACTED].

149 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 Ten Lakhs upon CA Lavitha Shetty. In addition, CA Lavitha Shetty is debarred for a period of Ten 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”. The first five years out of the ten years debarment ordered, will run concurrently with the period of debarment ordered vide our order dated 13.04.2023 in the case of CA Lavitha Shetty.

150 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

एनएफआरए के कार्यकारी निकाय द्वारा जारी करने के लिए अधिकृत,



सचिव, एनएफआरए

Date: 25.04.2023

Place: 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,
Chikkamgaluru-Pincode: 577101.
Karnataka.
E-mail: calavithas@gmail.com

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

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.

