KPMG in India's Voices on Reporting Bytes

Topic: Guidance on limited review of audits

Ruchi: Hello and welcome to KPMG in India's Voices on Reporting Bytes. In today's session we will be discussing a recent SEBI's circular which discusses the requirements of a principal auditor and component auditor in the case of a large group, which has various subsidiaries, associates and joint ventures. I am today joined by Mr. Sethuraman Sivaramakrishnan, who is an eminent panelist and a thought leader on accounting and auditing matters.

Sethuraman: Hi, Ruchi, thanks for inviting me to this forum. Happy to share my thoughts and views on this topic.

Q1 Ruchi: So Sethuraman, can you please explain the requirements of this circular and how do this requirements benchmark to the International Standards on Auditing?

Sethuraman: Sure. Ruchi, first for us to understand what this new guidelines are about, it important for us to also understand and appreciate the background to this entire set of guidelines and the genesis to this set of guidelines and the amendments which have been made by SEBI actually goes back to the Kotak Committee and as you are aware, the SEBI had constituted a committee under the chairmanship of Mr. Uday Kotak to look at various aspects relating to corporate governance and one of the aspects which the committee specifically looked into was the matter relating to group audits. There are many corporates in the country which required to consolidate the accounts of the various subsidiary, associates and joint ventures and some of them could be in India and some of them could be overseas and this could be typically audited by other auditors as well. So, the Indian scenario is different from the International scenario on this and that's largely because the framework of the Standards which governs this are also different.

So, just to give an examples, the International Standards on Auditing would typically expect the auditor of the parent to take responsibility in respect of the work done by the component auditor and when I say component what I actually mean is the joint venture or subsidiary of associates whose accounts are getting consolidated into the parent company.

Similarly, if you look at the US Standards on Auditing, the principal auditor (which is the auditor of the parent) again perform a set of procedures before he draws reference to the name of the auditor of the component in his own report of the consolidated financial statement. But in India the Standard is consciously different. There is a specific Standard called SA-600 which essentially talks about 'Using the work of another auditor'. And the way this is different is in India you don't take responsibility as a principal auditor for the audit work which is done by the component auditor and to that extent there was a question as to whether sufficient diligent is being exercised at a parent company auditor level in the country. So that's exactly what the Kotak Committee actually deliberated and came up with the set of recommendations and comments which the SEBI took on Board and SEBI essentially made an amendment to what we refer to as Regulation 33 to the Listing Obligation and Disclosure Requirements and said that the principal auditor is required to perform the limited review of the audit of the financial statements of the companies which are getting consolidated into the parent company's financials.

Q2 Ruchi: Sethu, you've mentioned a new term 'Limited Review of Audit'. How should companies be interpreting this term?

Sethuraman: Perhaps this is the core of entire deliberation. The topic of 'Limited Review' is well understood by both corporates as well as by auditors as well. Similarly the term 'Audit' is well understood both by the corporates and the auditing fraternity. But there is no defined framework for what is the meaning of 'Limited Review of the Audit' and this is exactly what created a lack of clarity as to what is therefore the expectations which the SEBI has actually set out because there is already an existing set of framework which as I mentioned primarily the Standards on Auditing-600 and similarly there is also another framework which is the 'Guidance Note' issued by Institute Of Chartered Accountants on what is referred as 'Guidance Note on the Audit of Consolidated Financial Statements'. So this clarity, lack of clarity was regarding how does this amendment of SEBI relating to Limited Review of Audit fit into the framework which is already existing? And that is the reason why SEBI actually constituted a committee and requested the committee to provide certain guidelines so that this topic could be actually addressed.

Q3 Ruchi: This clarity is very important. However, could you explain this guidelines and how they applicable to companies? Are they applicable to all the companies in India?

Sethuraman: So this guidelines which the SEBI has issued are essentially a set of (they broadly have 2 components).

One is a set of procedure which the principal auditor is required to perform. So that he can get sufficient evidence before is places reliance on the work of the component auditor. So that's one thing which this guidelines contains.

The second thing which this guidelines have brought about is the set of new format as you are aware the SEBI has earlier issued a set of formats which are required to be followed by the auditors when the issue their limited review opinions or audit opinions. And in the context of listed companies, so this formats were consciously amended to bring about a little bit of onus and a conscious acknowledgment on the part of the principal auditor on this concept of what is their role and responsibility relative to the component auditor's work. So, essentially, there are two part to it, one is set of procedures and the second is a set of amendments to the formats of the reports.

Coming to the second part of question as to what categories of companies this guidelines are applicable to? Essentially, they are applicable to companies which are listed and their auditors. It is also applicable to those companies whose accounts are actually getting consolidated into this listed companies which is therefore subsidiaries, associates, joint ventures and auditors of those (which is the component auditors). What it does not however extends to, is a set of Insurance Companies because this guidelines currently do not extent to them but they do extent to banks.

So that is something which we need to keep at the back of our mind. From an applicability prospective this are pretty much co-terminus with the date of applicability of the original amendment to Regulation 33 which is 1st April 2019. So, this is the 1st Quarter which is the June 2019 when corporates and auditors need to actually analyse and understand and give effect to the impact of this guidelines.

Q4 Ruchi: Sethu explained this guidelines are applicable from this quarter could you also explain what would be this procedures and formats that are prescribed by SEBI in this particular circular?

Sethuraman: This procedures you know, typically are you know intended to cover what the principal auditor needs to do before he can place reliance or he's obtained sufficient evidence so that he can place reliance on the work done by the auditor of the component. But it is important to mention a couple of in principle points relating to this procedures. The first in-principal point is that this set of procedures are not by themselves comprehensive in other words this do not/ its not a list of all procedures or the only procedures which the principal auditor is required to perform so that's something we need to first understand and the second and the most important part which we need to understand is that this set of procedures are not intended to replace the prevailing standard or the framework which already exists under which the principal auditor does his work. So this merely augment what is there, provide clarity to what is already there. So that is the first set of principal points. What do this procedures contains per se? They typically extent to what is the understanding, what is the consolidation process which the company follows in preparing the consolidated financial statements, what is the kind of scoping which the principal auditor does as to what is included in his risk assessment of the consolidated financial statements. It would typically include what is the kind of findings of the component auditor and therefore what should the principal auditor be doing in relative to those findings. It would also include what are the reporting requirements which the principal auditor needs to do given the findings of the component auditor. So those are the kind of things which the procedure. It's a good articulation of a set of procedures which the principal auditor needs to do. But I would actually highlight one important aspects of this. It also contains a set of elements which needs to be included in the set of instructions which need to be provided by the parent company's auditor to the component auditor and this I think is the perhaps the best part of this guidelines because it establishes a good communication protocol between the two sets of auditors. It provides clarity and avoids confusion. So this guidelines also sort of you know provide what needs to be typically there in this instructions which are provided to the component auditor.

Q5 Ruchi: This is very useful. This procedures and guidelines. So the principal auditor needs to convey certain instructions to the component auditor. In practice, what would this instructions contain and also what the role is of companies vis-à-vis this instructions between the principal auditor and component auditor?

Sethuraman: Let me first address what would typically be there in this instructions and then I will come to your point on what are companies role in it.

From on instructions perspective, the instructions would typically contain matters relating to the ethical and independence consideration which the component auditor needs to confirm, what are the timelines by which the component auditor needs to report, what are the mechanism of reporting the finding by the component auditor. There could be typically uncorrected misstatements which the component auditor might identify. So those are also sort of reported back and therefore the instruction would contain what is the mechanism for doing those reporting. This are the typical things which are contained and equally important is also an instructions to the component auditor that he needs acknowledge and understands and will be in a position to adhere to this instructions and if there is challenge relating to that it provides an opportunity for the component auditor to communicate back to the main auditor as to what the challenges are. So this audit and review instructions is a very good communication channel is the way I look at it.

Coming to your other question on the role of the companies and this is very important one because this set of guidelines are not merely guidelines which are extending to the auditors but it is equally something which apply to the corporates. So the auditors cannot work in isolation. They need to

sort of deliberate with the Management, first at the parent company level as to what is the kind of consolidation process they follow, what are the various subsidiaries, what are the deliberations, what are the sort of various developments at the subsidiaries because only then they will be able to develop a plan which addresses the risk relating to the consolidated financial statement. So first this sort of interaction with the parent company management is very critical. The parent company's management then sort of extends its communication to the various components so that they are fully aware that this requirements are being communicated to the respective auditors and so that they facilitate the component auditors work in line with this instructions. So it's a pretty much two way traffic of communication and therefor the role extends to not just auditor but also the management of the parent, management of the component, the auditors of the component as well.

Q6 Ruchi: This procedure are very elaborate and would help companies to implement this guidelines in a very robust manner. I have a leading question, what if the principal auditor determines a certain component to be immaterial then how would the requirements of the Auditing Standards and this guidelines inter-play?

Sethuraman: Sure. This guidelines actually it is interesting that they acknowledge the exclusion of some non-significant components so to speak. So essentially the parent companies auditor by looking at the consolidated financial statement, looking at the risk in his assessments and judgement, he will determine what are the various significant components and what are the non-significant components. And the scope of his work extend to the significant component and based on what Kotak committee had indicated this guidelines also draw reference to fact that the coverage from a significant component perspective needs to extend such that the significant component in aggregate account for at the minimum 80% of either revenue, assets and the profits of the consolidated financial statements. So this is an important part of the guidelines and therefore it acknowledges the existence of significant and non-significant component and exclusion of some which are non-significant in aggregate.

Q7 Ruchi: I agree with you that the identification of significant component would be a matter of judgement. So what would be the role of component auditor in the audit of a large group?

Sethuraman: That's very important. You have raised an important point because while this guidelines are written to a large extent from the perspective of the auditor of the parent company the applicability is also extents to the auditor of the components. So in their role they would be first receiving a set of instructions in the context of their work on the component which they are auditing. So they need to look at it in terms of their ethical and independence consideration whether they meet those tests, whether they are in a position to meet those requirements and understand all the communication mechanism and the timelines and therefore have this dialogues with component management that look we need to report along this line and therefore the management of the component needs to provide the necessary platform and information and whatever is required for them to perform audit or review and if there are any challenges what is important is that they have a communication mechanism with the principal auditor and they should use that.

Q8 **Ruchi:** Sethu, this guidelines are very comprehensive and you have really explained us this guidelines in detail. Would you like to now summaries what is the impact they have on the companies and likely potential benefits the company could entail from them?

Sethuraman: Sure. In summery Ruchi, the way I look at it is, this is a very positive development. It should be read in the context that this are not replacing any existing set of Standards. This are augmenting and supporting and providing clarity on some of the existing standards. It sharpens the focus on

the reporting responsibility of the parent company at the consolidated level. It also by making amendments to the format creates a consciousness and an acknowledgment that this guidelines have been followed. So therefore there is fair amount of diligence which is brought about on the principal auditor before he actually places reliance on the work of another auditor. I think in the coming weeks, I am sure, most corporates and the auditors would be deliberating this and taking this on Board as to what their requirements are so that the communications can be rolled out appropriately. I would think this is a very positive development and would look at it in that light. Thank you

Ruchi: Thank you Sethu for explaining to us the concept of a principal auditor vis-à-vis the component auditor and what it entails in this particular circular. Indeed, this is a robust process and SEBI has done a lot to bring clarity into this fear. As we implement this particular circular and guidelines in this quarter, I am sure companies would have more learning to gain. So thank you so much and we will reconvene again in our next session.