CHAPTER 16

PROFESSIONAL AND ETHICAL DUTY OF A CHARTERED ACCOUNTANT



LEARNING OUTCOMES

After studying this chapter, you will be able to:

- Comply with the Code of Ethics, Fundamental Principles and Conceptual Framework (applicable to all Chartered Accountants); and
- Comply with the Code of Ethics relevant for the Chartered Accountants in Service and Practice.
- Realise the implications of various Schedules of Chartered Accountants Act relating to professional and other misconduct.

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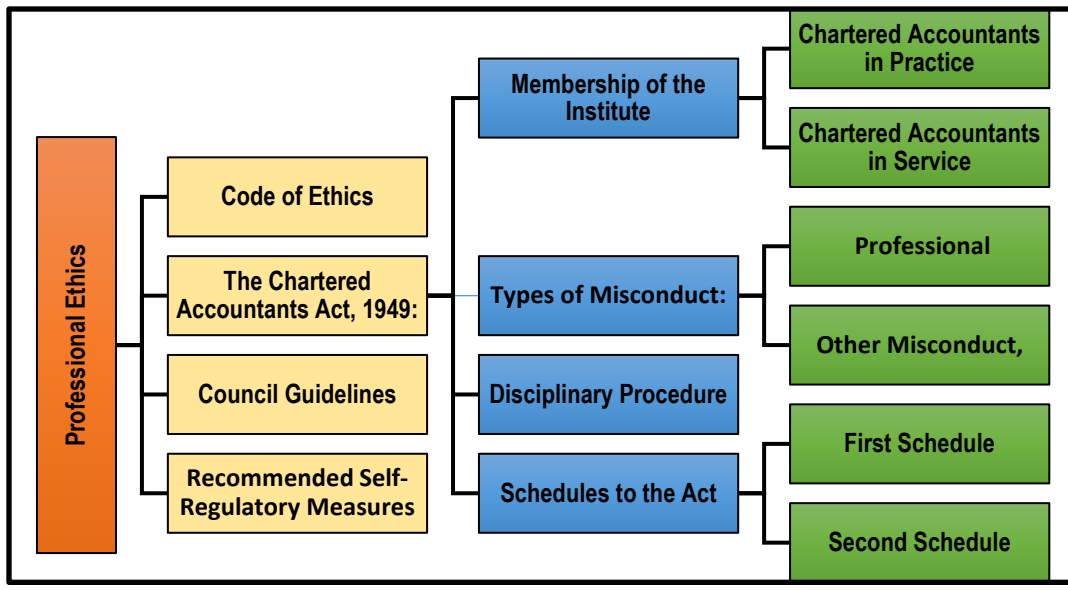
CHAPTER OVERVIEW



1. WHAT ARE ETHICS?

The Merriam-Webster dictionary defines ethic / ethics to be a set of moral principles: a theory or system of moral values, the principles of conduct governing an individual or the discipline dealing with what is good and bad and with moral duty and obligation.

2. ETHICAL PRINCIPLES IN FINANCIAL REPORTING

ICAI's Code of Ethics (2019), the "Code", which was developed on adopting the provisions of International Federation of Accountants (IFAC) Code of Ethics for the Chartered Accountants identifies the fundamental principles relevant to accountants. This Code of Ethics is applicable from 1st July, 2020.

This Code has been derived from the International Ethics Standards Board for Accountants (IESBA) Code of Ethics, 2018 issued by the International Federation of Accountants (IFAC).

A. The Code of Ethics ("the Code") sets out fundamental principles of ethics for Chartered Accountants (hereinafter also called as "accountants"), reflecting the recognition and

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responsibility of the profession 'chartered accountant' in public interest. These principles establish the standard of behaviour expected of a Chartered Accountant.

B. The Code provides a conceptual framework that Chartered Accountants are to apply in order to identify, evaluate and address threats to compliance with the fundamental principles. The Code sets out requirements and application material on various topics to help accountants apply the conceptual framework to those topics.

Note: The principles laid down in the Code of Ethics pertaining to the case of audits, reviews and other assurance engagements, including Independence Standards, established by the application of the conceptual framework to threats to independence in relation to these engagements are dealt with in detail in the 'Advanced Auditing, Assurance and Professional Ethics'.

3. THE CHARTERED ACCOUNTANTS ACT, 1949

A person qualifying as a Chartered Accountant becomes the member on registration with the Institute of the Chartered Accountants of India. Every member has to carry on their professional and other conduct as per the Chartered Accountants Act, 1949.

A member is liable to disciplinary action under Section 21 of the Chartered Accountants Act, if he is found guilty of any Professional or Other Misconduct.

4. WHAT IS PROFESSIONAL OR OTHER MISCONDUCT FOR A CHARTERED ACCOUNTANT?

According to section 22 of the Act, the expression "professional or other misconduct" shall be deemed to include any act or omission provided in any of the Schedules (of the Act).

4.1 Professional Misconduct

Professional misconduct has been defined in Part I, II and III of the First Schedule; and Part I and II of the Second Schedule. A member who is engaged in the profession of accountancy whether in practice or in service should conduct/restrict his actions in accordance with the provisions contained in the respective parts of the schedules. If the member is found guilty of any of the acts or omissions stated in any of the respective parts of the Schedule, he/she shall be deemed to be guilty of professional misconduct.

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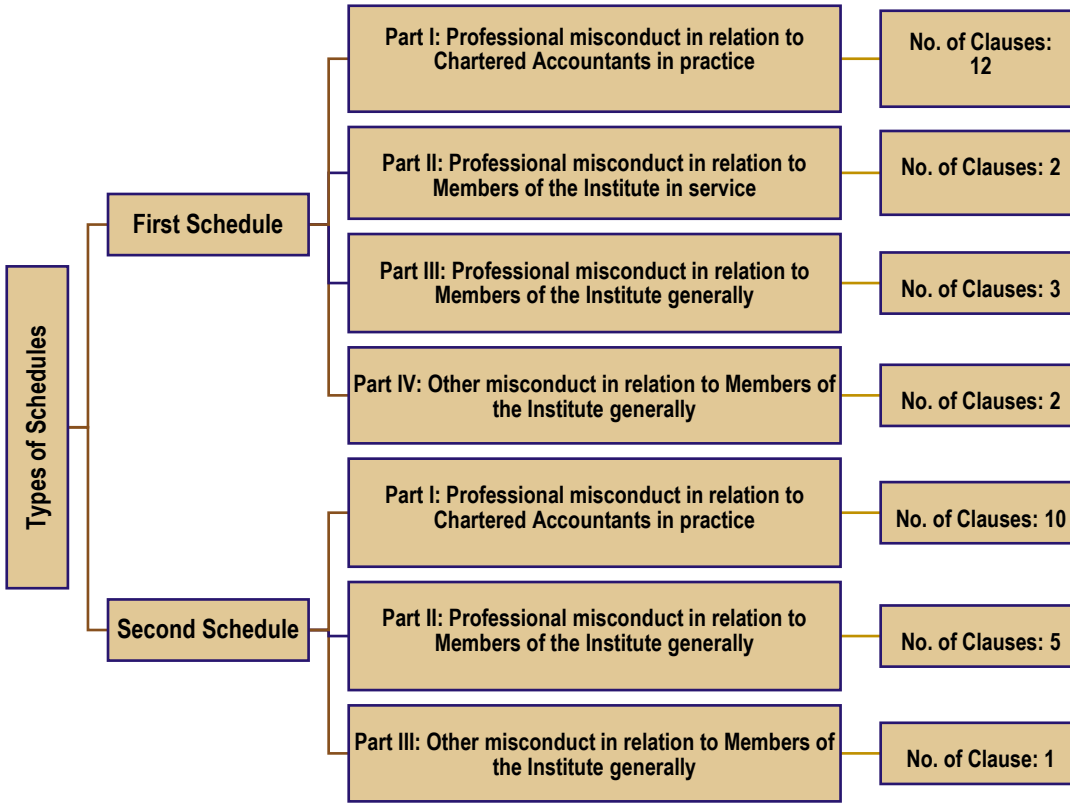
4.2 Other Misconduct

Other misconduct has been defined in Part IV of the First Schedule and Part III of the Second Schedule. These provisions empower the Council to inquire into any misconduct of a member even if it does not arise out of his professional work. This is considered necessary because a chartered accountant is expected to maintain the highest standards of integrity even in his personal affairs and any deviation from these standards, even in his non-professional work, would expose him to disciplinary action.



The clauses covered in Part I, II and III of Second Schedule have been shown in the form of flowchart below. However, for detail explanation, one must refer the Chapter on 'Professional Ethics' of Final Paper 3 'Advanced Auditing, Assurance and Professional Ethics'.

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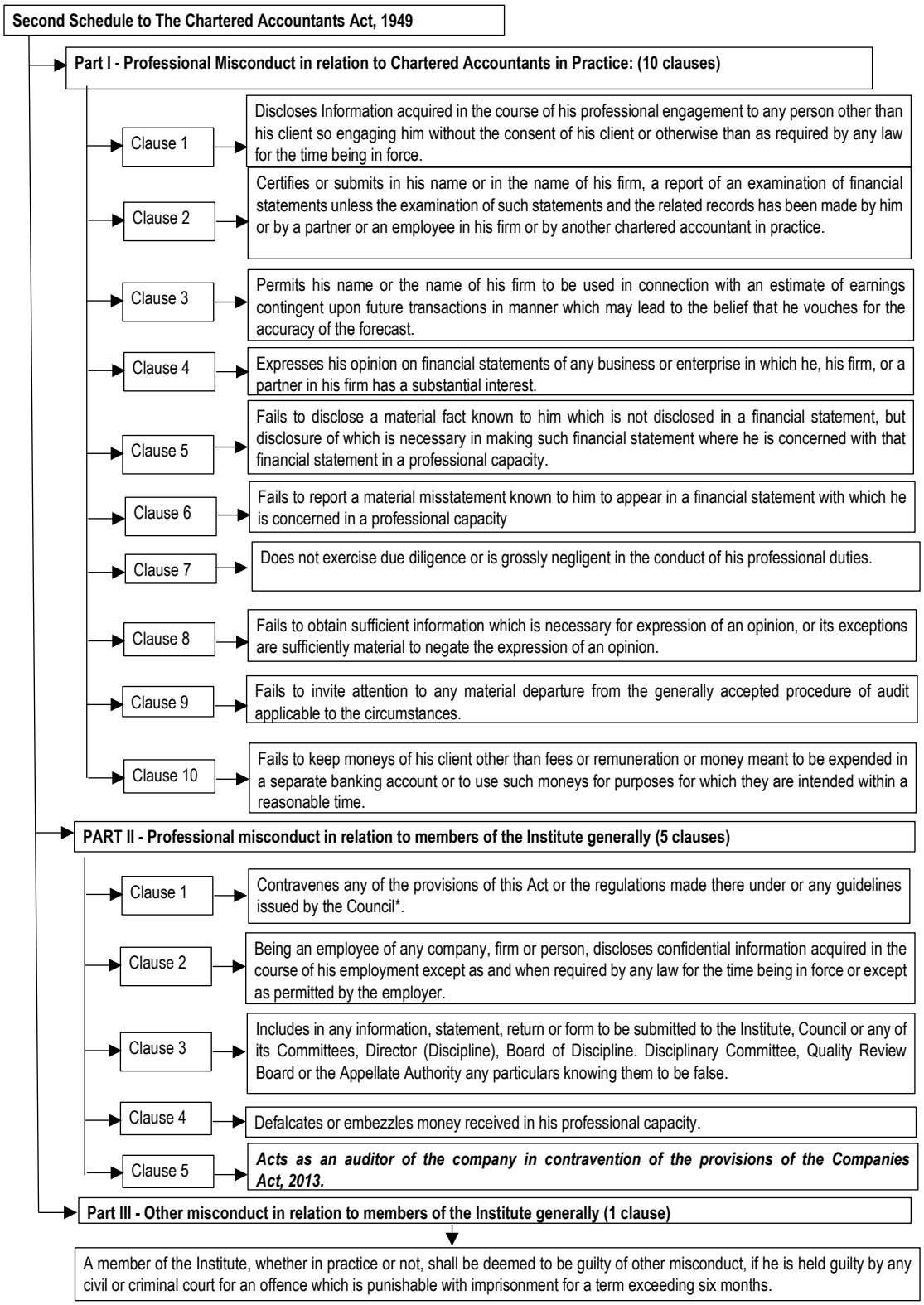

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***Note : Council Guidelines**

For conduct of a member being an employee, the Council Guidelines in its Appendix 34 of the Chartered Accountants Act, 1949, states that a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

The following part of the Code of Ethics shall be dealt with in Financial Reporting:

- Complying with the Code, Fundamental Principles and Conceptual Framework (applicable to all Chartered Accountants) (relevant part of this Section covered in detail in subsequent pages); and
- Chartered Accountants in Service (relevant part of this Section covered in detail in subsequent pages).

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PART 1: COMPLYING WITH THE CODE, FUNDAMENTAL PRINCIPLES AND CONCEPTUAL FRAMEWORK

1. COMPLYING WITH THE CODE

A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. A Chartered Accountant's responsibility is not exclusively to satisfy the needs of an individual client or employing organization. Therefore, the Code contains requirements and application material to enable Chartered Accountants to meet their responsibility to act in the public interest.

A Chartered Accountant shall comply with the Code. There might be circumstances where laws or regulations preclude an accountant from complying with certain parts of the Code. In such circumstances, those laws and regulations prevail, and the accountant shall comply with all other parts of the Code.

The principle of professional behaviour requires a Chartered Accountant to comply with relevant laws and regulations. Accountants need to be aware of differences in local regulations from the provisions as set out in the Code and comply with the more stringent provisions unless prohibited by law or regulation.

2. THE FUNDAMENTAL PRINCIPLES

There are five fundamental principles of ethics for chartered accountants:

(a) Integrity – to be straightforward and honest in all professional and business relationships.

(b) Objectivity – to exercise professional or business judgment without being compromised by:

- ***(i) Bias;***
- ***(ii) Conflict of interest; or***
- ***(iii) Undue influence of, or undue reliance on, individuals, organizations, technology or other factors.***

(c) Professional Competence and Due Care – to:

- ***(i) Attain and maintain professional knowledge and skill at the level required to ensure that a client or employing organization receives competent***

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professional service, based on current technical and professional standards and relevant legislation; and

(ii) Act diligently and in accordance with applicable technical and professional standards.

(d) Confidentiality – to respect the confidentiality of information acquired as a result of professional and business relationships.

(e) Professional Behaviour – to:

(i) Comply with relevant laws and regulations;

(ii) Behave in a manner consistent with the profession's responsibility to act in the public interest in all professional activities and business relationships; and

(iii) Avoid any conduct that the chartered accountant knows or should know might discredit the profession.

A chartered accountant shall comply with each of the fundamental principles.

The fundamental principles of ethics establish the standard of behaviour expected of a chartered accountant. The conceptual framework establishes the approach which an accountant is required to apply in complying with those fundamental principles.

A chartered accountant might face a situation in which complying with one fundamental principle conflicts with complying with one or more other fundamental principles. In such a situation, the accountant might consider consulting, with:

- *Others within the firm or employing organization.*
- *Those charged with governance.*
- *Institute*
- *Legal counsel.*

However, such consultation does not relieve the accountant from the responsibility to exercise professional judgment to resolve the conflict or, if necessary, and unless prohibited by law or regulation, disassociate from the matter creating the conflict.

The chartered accountant is encouraged to document the substance of the issue, the details of any discussions, the decisions made and the rationale for those decisions.

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3. INTEGRITY

A chartered accountant shall comply with the principle of integrity, which requires an accountant to be straightforward and honest in all professional and business relationships.

A chartered accountant shall comply with the principle of honesty, which requires an accountant to be honest and upright as a citizen, and in the personal affairs.

Integrity involves fair dealing, truthfulness and having the strength of character to act appropriately, even when facing pressure to do otherwise or when doing so might create potential adverse personal or organizational consequences.

Acting appropriately involves:

(a) Standing one's ground when confronted by dilemmas and difficult situations; or

(b) Challenging others as and when circumstances warrant, in a manner appropriate to the circumstances.

A chartered accountant shall not knowingly be associated with reports, returns, communications or other information where the accountant believes that the information:

(a) Contains a materially false or misleading statement;

(b) Contains statements or information provided in grossly negligent manner or

(c) Omits or obscures required information where such omission or obscurity would be misleading.

If a chartered accountant provides a modified report in respect of such a report, return, communication or other information, the accountant is not in breach of the above points.

4. OBJECTIVITY

A chartered accountant shall comply with the principle of objectivity, which requires an accountant to exercise professional or business judgment without being compromised by:

(a) Bias;

(b) Conflict of interest; or

(c) Undue influence of, or undue reliance on, individuals, organizations, technology or other factors.

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A chartered accountant shall not undertake a professional activity if a circumstance or relationship unduly influences the accountant's professional judgment regarding that activity.

Illustration 1:

Infostar Ltd. is a listed company engaged in the provision of IT services in India. The directors are paid a bonus based on the profits achieved by the company during the year as per the bonus table given below:

Range of Profit after tax	*Bonus to Directors*
Less than ₹ 1 crore	*NIL*
₹ 1 crore to < ₹ 5 crores	*2% of Net Profit after tax*
₹ 5 crores to < ₹ 10 crores	*4% of Net Profit after tax*
₹ 10 crores to < ₹ 20 crores	*6% of Net Profit after tax*
₹ 20 crores to < ₹ 30 crores	*8% of Net Profit after tax*
₹ 30 crores and above	*10% of Net Profit after tax*

The draft Statement of Profit and Loss for the year ended 31 March 20X2 currently shows a profit of ₹ 2 crores.

Issue:

On 25 March 20X2, Infostar Ltd. sold land located adjacent to its head office to a third party Zest Ltd. for a consideration of ₹ 40 crores, with an option to purchase the land back on 25 May 20X2 for ₹ 40 crores plus a premium of 6%. The amount received from the transaction eliminated the bank overdraft of Infostar Ltd. as on 31 March 20X2. On instructions of the Chief Financial Officer of the company, who is a chartered accountant, the transaction was treated as a sale, including the profit arising on disposal in the Statement of Profit and Loss for the year ending 31 March 20X2.

Required:

Discuss the ethical and accounting implications of the above issues with respect to a chartered accountant in service, referring to the relevant Ind AS wherever appropriate.

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Solution

Accounting Treatment

The sale of land meets the conditions specified in Ind AS 115, *Revenue from Contracts with Customers* for qualifying as a repurchase agreement as Infostar Ltd. has an option to buy back the land from Zest Ltd. and therefore, control is not transferred as Zest Ltd.'s ability to use and gain benefit from the land is limited. Infostar Ltd. must treat the transaction as a financing arrangement and record both the asset (land) and the financial liability (the amount received which is repayable to Zest Ltd.).

Infostar Ltd. should not have derecognized the land from the financial statements because the risks and rewards of ownership are not transferred. Thus, the substance of the transaction is a loan of ₹ 40 crores, with the 6% 'premium' on repurchase effectively reflecting interest payment.

Recording the aforesaid transaction as a sale is an attempt to manipulate the financial statements in order to show an improved profit figure and a more favourable cash position. The sale must be reversed and the land should be reinstated at its carrying amount prior to the transaction.

Ethical Issues

Chartered Accountants are required to comply with the fundamental principles laid down in the Code of Ethics. This includes acting with integrity. It appears that the integrity of CFO is compromised in this situation as he had accounted the transaction as sale and not as a loan or financial arrangement. The effect of accounting it as sale just before the year end is merely to improve profits and eliminate the bank overdraft, thereby making the cash position seem better than it is. This effectively amounts to 'window dressing', which is not honest as it does not present the actual performance and position of Infostar Ltd.

Accountants must also act with objectivity, which means they must not allow bias, conflict or undue influence of others to override professional or business judgments. Therefore, the management must put the interests of the company and the shareholders before their own interests. The pressure to show profits and achieve a bonus is in the self-interest of the directors and seems to have been partly driven the transaction and the subsequent accounting, which is clearly a conflict of interest.

It is further necessary for the accountants to comply with the principles of professional behaviour, which require compliance with relevant laws and regulations. In the instant case, the accounting treatment is not in conformity with Ind AS. The given facts do not make it clear whether CFO is aware of this or not. If he is aware but still applied the incorrect treatment, he has not complied

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with the principle of professional behaviour. It may be that he was under undue pressure from the directors to record the transaction in this manner. If, however, he is not aware that the treatment is incorrect, then he has not complied with the principle of professional competence as his knowledge and skills are not updated.

In such a case, he is subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949. Clause 1 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

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5. PROFESSIONAL COMPETENCE AND DUE CARE

A chartered accountant shall comply with the principle of professional competence and due care, which requires an accountant to:

(a) Attain and maintain professional knowledge and skills at the level required to ensure that a client or employing organization receives competent professional service, based on current technical and professional standards and relevant legislation; and

(b) Act diligently and in accordance with applicable technical and professional standards.

Serving clients and employing organizations with professional competence involves the exercise of sound judgment in applying professional knowledge and skills.

The knowledge and skills necessary for a professional activity vary depending on the nature of the activity being undertaken. For example, in addition to the application of any technical knowledge relevant to the professional activity, interpersonal, communication and organizational skills facilitate the chartered accountant's interaction with entities and individuals with whom the accountant interacts.

Maintaining professional competence requires a chartered accountant to have a continuing awareness and understanding of technical, professional, business and technology-related developments relevant to the professional activities undertaken by the accountant. Continuing professional development enables an accountant to develop and maintain the capabilities to perform competently within the professional environment.

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Diligence encompasses the responsibility to act in accordance with the requirements of an assignment, carefully, thoroughly and on a timely basis.

In complying with the principle of professional competence and due care, a chartered accountant shall take reasonable steps to ensure that those working in a professional capacity under the accountant's authority have appropriate training and supervision.

Where appropriate, a chartered accountant shall make clients, the employing organization, or other users of the accountant's professional activities, aware of the limitations inherent in the activities and explain the implications of those limitations.

Illustration 2:

Rustom Ltd., a company engaged in oil extraction, has a present obligation to dismantle the oil rig installed by it at the end of the useful life of 10 years. Rustom Ltd. cannot cancel this obligation or transfer it. Rustom Ltd. intends to carry out the dismantling work itself and estimates the cost of the work to be ` 100 crores at the end of 10 years.

The directors of Rustom Ltd. are aware of the requirements of Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets', read with Ind AS 16 'Property, Plant and Equipment'. However, they propose to expense the costs of dismantling the oil rig as and when incurred, with no entries or disclosures in the latest financial statements. They argue that application of Ind AS involves judgment, and although prudence is mentioned in the Conceptual Framework, it is only one among the many ways of achieving faithful representation.

Required:

Discuss whether the directors are acting unethically in the above instance what should be the practising Chartered Accountant's course of action in this regard.

Solution

The treatment proposed by the director is in contravention of Ind AS 37. As per Ind AS 16 and Ind AS 37, an entity, at the time of initial recognition of the asset, capitalises the present value of the cost of dismantling to be occurred at the end of the life of the asset, to the cost of the asset by simultaneously creating a provision for the same. In the given case, it appears to be a deliberate intention to contravene Ind AS 16 and Ind AS 37, and not an unintentional mistake.

Though the directors can exercise strong or undue influence over the chartered accountant, the chartered accountant is bound to act with integrity and remain unbiased, recommending to the directors that Ind AS 16 and Ind AS 37 must be complied with, and ensure appropriate entries are passed in the financial statements. The matter may be raised before the non-executive directors,

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explaining the issue to them and ensure the financial statements are true and fair and comply with the relevant Ind AS.

It is essential for the chartered accountant to inform those in governance (directors) about the necessary corrective measures in this case. By doing so, he uphold the fundamental principle of professional behaviour and demonstrate compliance with relevant laws and regulations. By communicating the corrective measures to those responsible for governance, the chartered accountant can ensure that the contravention of Ind AS 16 and Ind AS 37 is addressed and rectified.

However, if he does not communicate the corrective measures to the directors, the fundamental principle of **professional behaviour** will be breached. Members should comply with relevant laws and regulations and avoid any action that discredits the profession. By knowingly allowing the directors not to apply the requirements of an Ind AS, the Chartered Accountant would not be acting diligently in accordance with applicable guidance and would not be demonstrating professional competence and due care. In such a situation, he will be subject to professional misconduct under Clauses 5, 6 and 7 of Part I of Second Schedule of the Chartered Accountants Act, 1949.

Clause 5 states that a chartered accountant is guilty of professional misconduct when he fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where he is concerned with that financial statement in a professional capacity.

Clause 6 states that a CA is guilty of professional misconduct when he fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity.

Clause 7 states that a Chartered Accountant is guilty of professional misconduct when he does not exercise due diligence or is grossly negligent in the conduct of his professional duties.

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6. CONFIDENTIALITY

A Chartered Accountant shall comply with the principle of confidentiality, which requires an accountant to respect the confidentiality of information acquired as a result of professional and employment relationships. An accountant shall:

(a) Be alert to the possibility of inadvertent disclosure, including in a social environment, and particularly to a close business associate or an immediate or a close family member;

(b) Maintain confidentiality of information within the firm or employing organization;

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(c) Maintain confidentiality of information disclosed by a prospective client or employing organization;

(d) Take reasonable steps to ensure that personnel under the accountant's control, and individuals from whom advice and assistance are obtained, respect the accountant's duty of confidentiality.

Maintaining the confidentiality of information acquired in the course of professional and business relationships involves the chartered accountant taking appropriate action to protect the confidentiality of such information in the course of its collection, use, transfer, storage or retention, dissemination and lawful destruction.

A chartered accountant shall not:

(a) Disclose confidential information acquired in the course of professional and business relationships;

(b) Use confidential information acquired in the course of professional and business relationships for the advantage of the accountant, the firm, the employing organization or a third party;

(c) Use or disclose any confidential information, either acquired or received in the course of a professional or business relationship, after that relationship has ended; and

(d) Use or disclose information in respect of which the duty of confidentiality applies notwithstanding that the information has become publicly available, whether properly or improperly.

As an exception, a chartered accountant may disclose or use confidential information where:

(a) There is a legal or professional duty or right to do so; or

(b) This is authorized by the client or any person with the authority to permit disclosure or use of the confidential information and this is not prohibited by law or regulation.

Confidentiality serves the public interest because it facilitates the free flow of information from the Chartered Accountant's client or employing organization to the accountant in the knowledge that the information will not be disclosed to a third party. Nevertheless, the following are circumstances where Chartered Accountants might be required or ***have the duty or right*** to disclose confidential information:

(a) Disclosure is required by law, for example:

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(i) Production of documents or other provision of evidence in the course of legal proceedings; or

(ii) Disclosure to the appropriate public authorities of infringements of the law that come to light;

(b) There is a professional duty or right to disclose or use, when not prohibited by law or regulation:

(i) To comply with the requirements of peer review or quality review or such other review by the Institute

(ii) To respond to an inquiry or investigation by the Institute or other regulator;

(iii) To protect the professional interests of a Chartered Accountant in legal proceedings; or meet the ends of justice in legal proceedings when demanded by the court.

In deciding whether to disclose or use confidential information, factors to consider, depending on the circumstances, include:

- ***Whether the interests of any parties, including third parties whose interests might be affected, could be harmed if the client or employing organization authorizes the disclosure or use of information by the chartered accountant.***
- ***Whether all the relevant information is known and substantiated, to the extent practicable. Factors affecting the decision to disclose or use, the information include:***
  - ***Unsubstantiated facts.***
  - ***Incomplete information.***
  - ***Unsubstantiated conclusions.***
- ***The proposed means of communicating the information.***
- ***Whether the parties to whom the information is to be provided or access is to be granted are appropriate recipients.***
- ***Any applicable law or regulation (including those governing privacy) in a jurisdiction where disclosure might take place and, if different, the jurisdiction where the confidential information originates.***

The circumstances in which a firm or employing organization seeks authorization to use or disclose confidential information, include where the information is to be used for training

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purposes, in the development of products or technology, in research or as source material for industry or other benchmarking data or studies. Such authorization might be general in its application (for example, in relation to use of the information for internal training purposes or quality enhancement initiatives). When obtaining the authorization of the individual or entity that provided such information for use in specific circumstances, relevant considerations to be communicated (preferably in writing) might include:

- ***The nature of the information to be used or disclosed.***
- ***The purpose for which the information is to be used or disclosed (for example, technology development, research or benchmarking data or studies).***
- ***The individual or entity who will undertake the activity for which the information is to be used or disclosed.***
- ***Whether the identity of the individual or entity that provided such information or any individuals or entities to which such information relates will be identifiable from the output of the activity for which the information is to be used or disclosed.***

A Chartered Accountant shall continue to comply with the principle of confidentiality even after the end of the relationship between the accountant and a client or employing organization. When changing employment or acquiring a new client, the accountant is entitled to use prior experience but shall not use or disclose any confidential information acquired or received in the course of a professional or employment relationship.

7. PROFESSIONAL BEHAVIOUR

A chartered accountant shall comply with the principle of professional behaviour, which requires an accountant to:

(a) Comply with relevant laws and regulations;

(b) Behave in a manner consistent with the profession's responsibility to act in the public interest in all professional activities and business relationships; and

(c) Avoid any conduct that the accountant knows or should know might discredit the profession.

A chartered accountant shall not knowingly engage in any employment, occupation or activity that impairs or might impair the integrity, objectivity or good reputation of the profession, and as a result would be incompatible with the fundamental principles.

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Conduct that might discredit the profession includes conduct that a reasonable and informed third party would be likely to conclude adversely affects the good reputation of the profession.

When promoting himself and his work, a Chartered Accountant shall not bring the profession into disrepute. A Chartered Accountant is required to conduct his affairs in a manner that he remains outside the boundaries of professional and other misconduct. A Chartered Accountant shall be honest and truthful and shall not make:

(a) Exaggerated claims for the services offered by, or the qualifications or experience of, the accountant; or

(b) Disparaging references or unsubstantiated comparisons to the work of others.

(c) Any direct or indirect measures to advertise any professional/other facts which are in violation of Advertisement Guidelines issued by the Council of the Institute from time to time.

The chartered accountant should ensure that the contents of an advertisement are true to the best of his knowledge and belief, and are in conformity with the Advertisement Guidelines, and be aware that the Institute does not own any responsibility, whatsoever, for such contents or claims by him. However, if a chartered accountant is in doubt about whether a form of proposed advertising is appropriate, the accountant is encouraged to consult with the Ethical Standards Board of ICAI.

THE CONCEPTUAL FRAMEWORK

The ***Chartered Accountant shall apply the*** conceptual framework to ***identify, evaluate and address threats to compliance with the fundamental principles***.

(a) Identify threats to compliance with the fundamental principles;

(b) Evaluate the threats identified; and

(c) Address the threats by eliminating or reducing them to an acceptable level.

When applying the conceptual framework, the Chartered Accountant shall:

(a) Have an inquiring mind;

(b) Exercise professional judgment; and

(c) Use the reasonable and informed third party test.

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Having an Inquiring Mind

An inquiring mind is a prerequisite to obtaining an understanding of known facts and circumstances necessary for the proper application of the conceptual framework.

Having an inquiring mind involves:

(a) Considering the source, relevance and sufficiency of information obtained, taking into account the nature, scope and outputs of the professional activity being undertaken; and

(b) Being open and alert to a need for further investigation or other action.

When considering the source, relevance and sufficiency of information obtained, the chartered accountant might consider, among other matters, whether:

- ***New information has emerged or there have been changes in facts and circumstances.***
- ***The information or its source might be influenced by bias or self-interest.***
- ***There is reason to be concerned that potentially relevant information might be missing from the facts and circumstances known to the accountant.***
- ***There is an inconsistency between the known facts and circumstances and the accountant's expectations.***
- ***The information provides a reasonable basis on which to reach a conclusion.***
- ***There might be other reasonable conclusions that could be reached from the information obtained.***

All chartered accountants should have an inquiring mind when identifying, evaluating and addressing threats to the fundamental principles. This prerequisite for applying the conceptual framework applies to all accountants regardless of the professional activity undertaken. Chartered accountants are also required to exercise professional skepticism, which includes a critical assessment of evidence.

Exercise of Professional Judgment

Professional judgment involves the application of relevant training, professional knowledge, skill and experience commensurate with the facts and circumstances, taking into account the nature and scope of the particular professional activities and the interests and relationships involved.

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Professional judgment is required when the Chartered Accountant applies the conceptual framework in order to make informed decisions about the courses of actions available and to determine whether such decisions are appropriate in the circumstances. ***In making this determination, the accountant might consider matters such as whether:***

- ***The accountant's expertise and experience are sufficient to reach a conclusion.***
- ***There is a need to consult with others with relevant expertise or experience.***
- ***The accountant's own preconception or bias might be affecting the accountant's exercise of professional judgment.***

The circumstances in which chartered accountants carry out professional activities and the factors involved vary considerably in their range and complexity. The professional judgment exercised by accountants might need to take into account the complexity arising from the compounding effect of the interaction between, and changes in, elements of the facts and circumstances that are uncertain and variables and assumptions that are interconnected or interdependent.

Managing complexity involves:

- ***Making the firm or employing organization and, if appropriate, relevant stakeholders aware of the inherent uncertainties or difficulties arising from the facts and circumstances.***
- ***Being alert to any developments or changes in the facts and circumstances and assessing whether they might impact any judgments the accountant has made.***

Managing complexity might also involve:

- ***Analyzing and investigating as relevant, any uncertain elements, the variables and assumptions and how they are connected or interdependent.***
- ***Using technology to analyze relevant data to inform the chartered accountant's judgment.***
- ***Consulting with others, including experts, to ensure appropriate challenge and additional input as part of the evaluation process.***

Reasonable and Informed Third Party

The reasonable and informed third party test is a consideration by the Chartered Accountant about whether the same conclusions would likely be reached by another party. Such consideration is made from the perspective of a reasonable and informed third party, who weighs all the relevant

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facts and circumstances that the accountant knows, or could reasonably be expected to know, at the time the conclusions are made. The reasonable and informed third party does not need to be an accountant but would possess the relevant knowledge and experience to understand and evaluate the appropriateness of the accountant's conclusions in an impartial manner.

Identifying Threats

The chartered accountant shall identify threats to compliance with the fundamental principles.

An understanding of the facts and circumstances, including any professional activities, interests and relationships that might compromise compliance with the fundamental principles, is a prerequisite to the chartered accountant's identification of threats to such compliance. The existence of certain conditions, policies and procedures established by the profession, legislation, regulation, the firm, or the employing organization that can enhance the accountant acting ethically might also help identify threats to compliance with the fundamental principles.

Threats to compliance with the fundamental principles might be created by a broad range of facts and circumstances. It is not possible to define every situation that creates threats. In addition, the nature of engagements and work assignments might differ and, consequently, different types of threats might be created.

Threats to compliance with the fundamental principles fall into one or more of the following categories:

(a) Self-interest threat – the threat that a financial or other interest will inappropriately influence a chartered accountant's judgment or behaviour;

(b) Self-review threat – the threat that a chartered accountant will not appropriately evaluate the results of a previous judgment made; or an activity performed by the accountant, or by another individual within the accountant's firm or employing organization, on which the accountant will rely when forming a judgment as part of performing a current activity;

(c) Advocacy threat – the threat that a chartered accountant will promote a client's or employing organization's position to the point that the accountant's objectivity is compromised;

(d) Familiarity threat – the threat that due to a long or close relationship with a client, or employing organization, a chartered accountant will be too sympathetic to their interests or too accepting of their work; and

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(e) Intimidation threat – the threat that a chartered accountant will be deterred from acting objectively because of actual or perceived pressures, including attempts to exercise undue influence over the accountant.

A circumstance might create more than one threat, and a threat might affect compliance with more than one fundamental principle.

If new information results in the identification of a new threat, the chartered accountant is required to evaluate and, as appropriate, address this threat.

Addressing Threats

If the chartered accountant determines that the identified threats to compliance with the fundamental principles are not at an acceptable level, the accountant shall address the threats by eliminating them or reducing them to an acceptable level. The accountant shall do so by:

(a) Eliminating the circumstances, including interests or relationships, that are creating the threats;

(b) Applying safeguards, where available and capable of being applied, to reduce the threats to an acceptable level; or

(c) Declining or ending the specific professional activity.

Actions to Eliminate Threats

Depending on the facts and circumstances, a threat might be addressed by eliminating the circumstance creating the threat. However, there are some situations in which threats can only be addressed by declining or ending the specific professional activity. This is because the circumstances that created the threats cannot be eliminated and safeguards are not capable of being applied to reduce the threat to an acceptable level.

Conscious or unconscious bias affects the exercise of professional judgment when identifying, evaluating and addressing threats to compliance with the fundamental principles.

Actions that might mitigate the effect of bias include:

- *Seeking advice from experts to obtain additional input.*
- *Consulting with others to ensure appropriate challenge as part of the evaluation process.*
- *Receiving training related to the identification of bias as part of professional development.*

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PART 2: CHARTERED ACCOUNTANTS IN SERVICE

A. CONFLICTS OF INTEREST

A Chartered Accountant shall not allow a conflict of interest to compromise professional or business judgment.

Examples of circumstances that might create a conflict of interest include:

(a) Serving in a management or governance position for two employing organizations and acquiring confidential information from one organization that might be used by the Chartered Accountant to the advantage or disadvantage of the other organization.

(b) Undertaking a professional activity for each of two parties in a partnership, where both parties are employing the accountant to assist them to dissolve their partnership.

(c) Preparing financial information for certain members of management of the accountant's employing organization who are seeking to undertake a management buy-out.

(d) Being responsible for selecting a vendor for the employing organization when an immediate family member of the accountant might benefit financially from the transaction.

(e) Serving in a governance capacity in an employing organization that is approving certain investments for the company where one of those investments will increase the value of the investment portfolio of the accountant or an immediate family member.

1. Conflict Identification

A Chartered Accountant shall take reasonable steps to identify circumstances that might create a conflict of interest, and therefore a threat to compliance with one or more of the fundamental principles. Such steps shall include identifying:

(a) The nature of the relevant interests and relationships between the parties involved; and

(b) The activity and its implication for relevant parties.

A chartered accountant shall remain alert to changes over time in the nature of the activities, interests and relationships that might create a conflict of interest while performing a professional activity.

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2. Threats created by Conflict of Interest

In general, the more direct the connection between the professional activity and the matter on which the parties' interests conflict, the more likely the level of the threat is not at an acceptable level.

An example of an action that might eliminate threats created by conflicts of interest is withdrawing from the decision-making process related to the matter giving rise to the conflict of interest.

Examples of actions that might be safeguards to address threats created by conflicts of interest include:

(a) Restructuring or segregating certain responsibilities and duties.

(b) Obtaining appropriate oversight, for example, acting under the supervision of an executive or non-executive director.

3. Disclosure and Consent

It is generally necessary to:

(a) Disclose the nature of the conflict of interest and how any threats created were addressed to the relevant parties, including to the appropriate levels within the employing organization affected by a conflict; and

(b) Obtain consent from the relevant parties for the Chartered Accountant to undertake the professional activity when safeguards are applied to address the threat.

Consent might be implied by a party's conduct in circumstances where the chartered accountant has sufficient evidence to conclude that the parties know the circumstances at the outset and have accepted the conflict of interest if they do not raise an objection to the existence of the conflict.

If such disclosure or consent is not in writing, the chartered accountant is encouraged to document:

(a) The nature of the circumstances giving rise to the conflict of interest;

(b) The safeguards applied to address the threats when applicable; and

(c) The consent obtained.

When addressing a conflict of interest, the Chartered Accountant is encouraged to seek guidance from within the employing organization or from the Institute, legal counsel or another accountant.

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When making such disclosures or sharing information within the employing organization and seeking guidance of third parties, the principle of confidentiality applies.

Illustration 3:

Alaap Ltd.'s directors feel that the company needs a significant injection of capital in order to modernize plant and equipment as the company has been promised firm orders if it can produce goods of international standards. The current lending policies of the banks require prospective borrowers to demonstrate strong projected cash flows, coupled with a Debt Service Coverage Ratio exceeding 10. However, the current projected statement of cash flows does not satisfy the bank's criteria for lending. The directors have told the bank that the company is in an excellent financial position, the financial results and cash flow projections will meet the criteria and the chartered accountant will submit a report to this effect shortly. The chartered accountant has recently joined Alaap Ltd. and has openly stated that he cannot afford to lose his job because of financial commitments.

Required:

Discuss the potential ethical conflicts which may arise in the above scenario and the ethical principles which would guide how the chartered accountant should respond to the situation.

Solution

The given scenario presents a twofold conflict of interest:

(i) *Pressure to obtain finance and chartered accountant's personal circumstances*

The chartered accountant is under pressure to provide the bank with a projected cash flow statement that will meet the bank's criteria when in fact the actual projections do not meet the criteria. The chartered accountant's financial circumstances mean that he cannot lose his job, thus **the ethical and professional standards required of the accountant are at odds with the pressures of his personal circumstances**.

(ii) *Duty to shareholders, employees and bank*

The **directors have a duty to act in the best interests of the company's shareholders and employees, and a duty to present fairly any information the bank may rely on**. The injection of capital to modernise plant and equipment appears to be for capacity expansion which will lead to greater profits, thus being in the interests of the shareholders and the employees. However, if such finance is obtained based on misleading information, it could actually be detrimental to the going concern status of the company.

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It could be argued that there is a **conflict between the short-term and medium-term interests of the company** (the need to modernise the company) **and its long-term interests** (the detriment to the company's reputation if its directors do not conform to ethics).

Ethical principles guiding the chartered accountant's response

The chartered accountant's financial circumstances coupled with the pressure from the directors could end up in him knowingly disclosing incorrect information to the bank, thereby compromising the fundamental principles of **objectivity, integrity** and **professional competence**.

By exhibiting **bias** due to the **risk of losing his job** through reporting favourable cash flows to the bank, **objectivity** is compromised. Further, **integrity** is also compromised as by not acting in a straightforward and honest manner, **incorrect information is knowingly disclosed**. Forecasts, unlike financial statements, do not specify that they have been prepared in accordance with Ind AS. However, the principle of **professional competence** requires the accountant to prepare the cash flow projections to the **best of his professional judgment** which would not be the case if the projections showed a more positive position than what is actually anticipated.

Appropriate action

The **chartered accountant faces an immediate ethical dilemma** and must apply his moral and ethical judgment. As a professional, he is responsible for presenting the truth, and not to indulge in 'creative accounting' owing to pressure.

Thus, **the chartered accountant should put the interests of the company and professional ethics first** and insist that the report to the bank be an honest reflection of the company's current financial position. Being an advisor to the directors, he must prevent deliberate misrepresentation to the bank, no matter what the consequences to him are personally. The accountant should not allow any undue influence from the directors to override his professional judgment or integrity. This is in the long-term interests of the company and its survival.

It is suggested that the chartered accountant should communicate to the directors to submit the projected statement of cash flows to the bank, which reflects the current position of the company.

Knowingly providing incorrect information is considered as professional misconduct. To prevent such misconduct, a chartered accountant should not provide incorrect projected cash flows to the bank and colour the financial position of the entity. By adhering to the ethical principles, the chartered accountant will maintain his professional integrity and contribute to the trust and reliability placed in the work expected from him.

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However, if he submits the incorrect projected statement of cash flows, he would be subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949. The Clause 1 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

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B. PREPARATION AND PRESENTATION OF INFORMATION

When preparing or presenting information, a Chartered Accountant shall:

(a) Prepare or present the information in accordance with a relevant reporting framework, where applicable;

(b) Prepare or present the information in a manner that is intended neither to mislead nor to influence contractual or regulatory outcomes inappropriately;

(c) Exercise professional judgment to:

  (i) Represent the facts accurately and completely in all material respects;

  (ii) Describe clearly the true nature of business transactions or activities; and

  (iii) Classify and record information in a timely and proper manner; and

(d) Not omit anything with the intention of rendering the information misleading or of influencing contractual or regulatory outcomes inappropriately.

(e) Avoid undue influence of, or undue reliance on, individuals, organizations or technology; and

(f) Be aware of the risk of bias.

An example of influencing a contractual or regulatory outcome inappropriately is using an unrealistic estimate with the intention of avoiding violation of a contractual requirement such as a debt covenant or of a regulatory requirement such as a capital requirement for a financial institution.

1. Use of discretion in preparing or presenting information

Preparing or presenting information might require the exercise of discretion in making professional judgments. The Chartered Accountant shall not exercise such discretion with the intention of misleading others or influencing contractual or regulatory outcomes inappropriately.

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Examples of ways in which discretion might be misused to achieve inappropriate outcomes include:

- Determining estimates, for example, determining fair value estimates in order to misrepresent profit or loss.
- Selecting or changing an accounting policy or method among two or more alternatives permitted under the applicable financial reporting framework, for example, selecting a policy for accounting for long-term contracts in order to misrepresent profit or loss.
- Determining the timing of transactions, for example, timing the sale of an asset near the end of the fiscal year in order to mislead.
- Determining the structuring of transactions, for example, structuring financing transactions in order to misrepresent assets and liabilities or classification of cash flows.
- Selecting disclosures, for example, omitting or obscuring information relating to financial or operating risk in order to mislead.

When performing professional activities, the Chartered Accountant shall exercise professional judgment to identify and consider:

(a) The purpose for which the information is to be used;

(b) The context within which the information is given; and

(c) The audience to whom it is addressed.

For example, when preparing or presenting pro forma reports, budgets or forecasts, the inclusion of relevant estimates, approximations and assumptions, where appropriate, would enable those who might rely on such information to form their own judgments.

2. Using the work of others

A Chartered Accountant who intends to use the work of others, whether internal or external to the employing organization, or other organizations shall exercise professional judgment to determine appropriate steps to take, if any, in order to fulfil the responsibilities.

Factors to consider when a chartered accountant intends to use the work of others include::

- The reputation and expertise of, and resources available to, the other individual or organization.
- Whether the other individual is subject to applicable professional and ethics standards.

Such information might be gained from prior association with, or from consulting others about, the other individual or organization.

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3. Using the output of technology

A chartered accountant who intends to use the output of technology, whether that technology was developed internally or provided by third parties, shall exercise professional judgment to determine the appropriate steps to take, if any, in order to fulfill the responsibilities.

Factors to consider when a chartered accountant intends to use the output of technology include:

- ***The nature of the activity to be performed by the technology.***
- ***The expected use of, or extent of reliance on, the output of the technology.***
- ***Whether the accountant has the ability, or has access to an expert with the ability, to understand, use and explain the technology and its appropriateness for the purpose intended.***
- ***Whether the technology used has been appropriately tested and evaluated for the purpose intended.***
- ***Prior experience with the technology and whether its use for specific purposes is generally accepted.***
- ***The employing organization's oversight of the design, development, implementation, operation, maintenance, monitoring, updating or upgrading of the technology.***
- ***The controls relating to the use of the technology, including procedures for authorizing user access to the technology and overseeing such use.***
- ***The appropriateness of the inputs to the technology, including data and any related decisions, and decisions made by individuals in the course of using the technology.***

4. Addressing information that is or might be misleading

When the Chartered Accountant knows or has reason to believe that the information with which the accountant is associated is misleading, the accountant shall take appropriate actions to seek to resolve the matter.

Actions that might be appropriate include:

- Discussing concerns that the information is misleading with the Chartered Accountant's superior and/or the appropriate level(s) of management within the accountant's employing organization or those charged with governance and requesting such individuals to take appropriate action to resolve the matter. Such action might include:

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- Having the information corrected.
- If the information has already been disclosed to the intended users, informing them of the correct information.

Consulting the policies and procedures of the employing organization (for example, an ethics or whistle-blowing policy) regarding how to address such matters internally

The Chartered Accountant might determine that the employing organization has not taken appropriate action. If the accountant continues to have reason to believe that the information is misleading, the following further actions might be appropriate provided that the accountant remains alert to the principle of confidentiality:

- Consulting with:
  - The Institute
  - The internal or external auditor of the employing organization
  - Legal counsel.
- Determining whether any requirements exist to communicate to:
  - Third parties, including users of the information.
  - Regulatory and oversight authorities.

If after exhausting all feasible options, the Chartered Accountant determines that appropriate action has not been taken and there is reason to believe that the information is still misleading, the accountant shall refuse to be or to remain associated with the information.

In such circumstances, it might be appropriate for a Chartered Accountant to resign from the employing organization.

5. Documentation

The chartered accountant is encouraged to document:

- ***The facts.***
- ***The accounting principles or other relevant professional standards involved.***
- ***The communications and parties with whom matters were discussed.***
- ***The courses of action considered.***
- ***How the accountant attempted to address the matter(s).***

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When a chartered accountant is considering using the work of others or the output of technology, a consideration is whether the accountant is in a position within the employing organization to obtain information in relation to the factors necessary to determine whether such use is appropriate.

Illustration 4:

Sunshine Ltd., a listed company in the cosmetics industry, has debt covenants attached to some of its borrowings which are included in Financial Liabilities in the Balance Sheet. These covenants mandate the company to repay the debt in full if Sunshine Ltd. fails to maintain a liquidity ratio and operating margin above the specified limit.

The directors alongwith the CFO of the Company who is a chartered accountant are considering entering into a fresh five-year leasing arrangement but are concerned about the negative impact any potential lease obligations may have on the above-mentioned covenants. Accordingly, the directors and CFO propose that the lease agreement be drafted in such a way that it is a series of six ten-month leases rather than a single five-year lease in order to utilize the short-term lease exemption available under Ind AS 116, Leases. This would then enable accounting for the leases in their legal form. The directors believe that this treatment will meet the requirements of the debt covenant, though such treatment may be contrary to the accounting standards.

Required:

Discuss the ethical and accounting implications of the above issue from the perspective of CFO.

Solution

Lease agreement substance presentation

Stakeholders make informed and accurate decisions based on the information presented in the financial statements and as such, ensuring the financial statements are reliable and of utmost importance. The directors of Sunshine Ltd. are ethically responsible to produce financial statements that comply with Ind AS and are transparent and free from material error. Lenders often attach covenants to the terms of the agreement in order to protect their interests in an entity. They would also be of crucial importance to potential debt and equity investors when assessing the risks and returns from any future investment in the entity.

The proposed action by Sunshine Ltd. appears to be a deliberate attempt to circumvent the terms of the covenants. The legal form would require treatment as a series of short-term leases which would be recorded in the profit or loss, without any right-of-use asset and lease liability being recognized as required by Ind AS 116, *Leases*. This would be a form of 'off-balance sheet finance'

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and would not report the true assets and obligations of Sunshine Ltd. As a result of this proposed action, the liquidity ratios would be adversely misrepresented. Further, the operating profit margins would also be adversely affected, as the expenses associated with the lease are likely to be higher than the deprecation charge if a leased asset was recognized, hence the proposal may actually be detrimental to the operating profit covenant.

Sunshine Ltd. is aware that the proposed treatment may be contrary to Ind AS. Such manipulation would be a clear breach of the fundamental principles of objectivity and integrity as outlined in the Code of Ethics. It is important for a chartered accountants to exercise professional behaviour and due care all the time. The proposals by Sunshine Ltd. are likely to mislead the stakeholders in the entity. This could discredit the profession by creating a lack of confidence within the profession. The directors of Sunshine Ltd. must be reminded of their ethical responsibilities and persuaded that the accounting treatment must fully comply with the Ind AS and principles outlined within the framework should they proceed with the financing agreement.

However, if the CFO fails to comply with his professional duties, he will be subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949. The Clause 1 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

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C. ACTING WITH SUFFICIENT EXPERTISE

A Chartered Accountant shall not intentionally mislead an employing organization as to the level of expertise or experience possessed.

The principle of professional competence and due care requires that a chartered accountant only undertake significant tasks for which the accountant has, or can obtain, sufficient training or experience.

A self-interest threat to compliance with the principle of professional competence and due care might be created if a Chartered Accountant has:

- Insufficient time for performing or completing the relevant duties.
- Incomplete, restricted or otherwise inadequate information for performing the duties.

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- Insufficient experience, training and/or education.
- Inadequate resources for the performance of the duties.

Factors that are relevant in evaluating the level of such a threat include:

- ***The extent to which the chartered accountant is working with others.***
- ***The relative seniority of the accountant in the business.***
- ***The level of supervision and review applied to the work.***

Examples of actions that might be safeguards to address such a self-interest threat include:

- Obtaining assistance or training from someone with the necessary expertise.
- Ensuring that there is adequate time available for performing the relevant duties.

If a threat to compliance with the principle of professional competence and due care cannot be addressed, a Chartered Accountant shall determine whether to decline to perform the duties in question. If the accountant determines that declining is appropriate, the accountant shall communicate the reasons.

Illustration 5:

Agastya Ltd. is a listed company engaged in the manufacturing of automotive spare parts. The company is preparing the financial statements for the year ended 31 March 20X3. The directors of Agastya Ltd. are entitled to an incentive based on the operating profit margin of the company. You have been appointed as a consultant to advise on the preparation of the financial statements, and you notice the following issue:

Issue:

On 1 April 20X2, Agastya Ltd.'s defined benefit pension scheme was amended to increase the pension entitlement from 12% of final salary to 18.5% of final salary. This amendment was made due to the salary cuts made on account of the pandemic. The chartered accountant has shown such increase in the pension entitlement (amounting to ₹ 85 crores) under the head 'Employee Benefits' forming part of the operating profit. The directors are unhappy with this presentation. They believe that the pension scheme is not integral to the operations of the company since it is paid post-retirement of the employees, and thus insist that such presentation would be misleading in computing the operating profit or loss. Accordingly, the directors propose a change in accounting policy so that all such gains or losses on pension scheme would be recognized under Other Comprehensive Income. The directors believe that this policy choice will make the financial

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statements more consistent, understandable thereby justifying the same on grounds of fair presentation as defined in the Framework. The pension scheme of Agastya Ltd. is currently in deficit.

Required:

Discuss the ethical and accounting implications of the above issues, referring to the relevant Ind AS wherever appropriate from the perspective of the consultant.

Solution

Ethical Implications of change in accounting policy

Ind AS 8, Accounting Policies, Changes in Accounting Estimates and Errors only permits a change in accounting policy if the change is: (i) required by an Ind AS or (ii) results in the financial statements providing reliable and more relevant information about the effects of transactions, other events or conditions on the entity's financial position, financial performance or cash flows. A retrospective adjustment is required unless the change arises from a new accounting policy with transitional arrangements to account for the change. It is permissible to depart from the requirements of Ind AS but only in extremely rare circumstances where compliance would be so misleading that it would conflict with overall objectives of the financial statements. Practically, this override is rarely, if ever, invoked.

Ind AS 19, Employee Benefits requires all gains and losses on a defined benefit pension scheme to be recognised in profit or loss except for the remeasurement component relating to plan assets and defined benefit obligations, which must be recognized in Other Comprehensive Income. Accordingly, current service cost, past service cost and net interest cost on the net defined benefit obligation must all be recognized in profit or loss. Ind AS 19 does not offer any alternative treatment as an accounting policy choice in terms of Ind AS 8, and therefore the directors' proposals cannot be justified on the grounds of fair presentation. The directors are ethically bound to prepare financial statements which reflect a true and fair view of the entity's performance and financial position and comply with all Ind AS.

It is the self-interest in the pension scheme that is making the directors consider a change in accounting policy in order to maximize profits for maximizing their bonus potential. The amendment to the pension scheme is a past service cost in terms of Ind AS 19 which should be expensed to the profit or loss during the period such plan amendment has occurred, i.e., immediately. This would impact the operating profits of Agastya Ltd. thereby reducing the potential bonus.

Additionally, it appears that the directors wish to manipulate aspects of the pension scheme such as current service cost and, since the pension scheme is given to be in deficit, the net finance cost.

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The directors are purposely manipulating the presentation of these items by recording them in equity instead of Profit or Loss. The financial statements would not be compliant with Ind AS and would not give a reliable picture of the true costs to the company of operating the pension scheme and this treatment would make the financial statements less comparable with other entities correctly applying Ind AS 19. Further, the explicit statement given in the financial statements stating that all compliance with Ind AS is achieved would be an incorrect statement to make in the event of the above non-compliance. Further, such treatment would be against the fundamental principles of objectivity, integrity and professional behaviour as stated in the Code of Ethics. The directors need to understand their ethical responsibilities and avoid implementing the proposed change in policy.

As a meaningful addition, the directors could use other tools/indicators within the financial statements to explain the company's results such as drawing attention of the users to the cash generated from operations which would exclude the non-cash pension expense. Alternative measures such as EBITDA could be disclosed where non-cash items are consistently eliminated for comparison purposes.

When a Chartered Accountant discovers that a company's financial position has been compromised through misstatement, they have two options. They can either report the non-compliance to the authorities or consider withdrawing from the engagement. Both the actions ensure integrity, transparency, and the interests of stakeholders at large.

In case the consultant-chartered accountant is influenced by the director's suggestions and report accordingly, he will be subject to professional misconduct under Clauses 5,7 and 8 of Part I of Second Schedule of the Chartered Accountants Act, 1949.

Clause 5 states that a Chartered Accountant is guilty of professional misconduct when he fails to disclose a material fact known to him which is not disclosed in a financial statement, but disclosure of which is necessary in making such financial statement where he is concerned with that financial statement in a professional capacity.

Clause 7 states that a Chartered Accountant is guilty of professional misconduct when he does not exercise due diligence or is grossly negligent in the conduct of his professional duties.

Clause 8 of Part I of the Second Schedule of the Chartered Accountants Act 1949 states that a CA is guilty of professional misconduct when he 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.

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D. FINANCIAL INTERESTS, COMPENSATION AND INCENTIVES LINKED TO FINANCIAL REPORTING AND DECISION MAKING

A Chartered Accountant shall not manipulate information or use confidential information for personal gain or for the financial gain of others.

Chartered Accountants might have financial interests or might know of financial interests of immediate or close family members that, in certain circumstances, might create threats to compliance with the fundamental principles. Financial interests include those arising from compensation or incentive arrangements linked to financial reporting and decision making.

Examples of circumstances that might create a self-interest threat include situations in which the Chartered Accountant or an immediate or close family member:

- Has a motive and opportunity to manipulate price- sensitive information in order to gain financially.
- Holds a direct or indirect financial interest in the employing organization and the value of that financial interest might be directly affected by decisions made by the accountant.
- Is eligible for a profit-related bonus and the value of that bonus might be directly affected by decisions made by the accountant.
- Holds, directly or indirectly, deferred bonus share rights or share options in the employing organization, the value of which might be affected by decisions made by the accountant.
- Participates in compensation arrangements which provide incentives to achieve targets or to support efforts to maximize the value of the employing organization's shares. An example of such an arrangement might be through participation in incentive plans which are linked to certain performance conditions being met.

Illustration 6:

The directors of Spinz Ltd. are eligible for an incentive computed as a percentage of 'Cash Generated from Operations' as defined in Ind AS 7, Statement of Cash Flows in accordance with the terms of their appointment. Due to the onset of the pandemic, the company has not performed well, and it has, in fact, lost Cash from Operations. In order to meet the cash requirements, the directors of Spinz Ltd. are planning to dispose off under-utilized equipment and investments (not subsidiaries or associates). The directors opine that since the cash generated from sale of such equipment and investments would be used for operations, the inflows on such sale would be presented in the Statement of Cash Flows under 'Cash from Operations'. The directors are concerned about meeting the targets in order to ensure security of their jobs and feel that this

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treatment would enhance the 'cash flow picture' of the business. The inflows on sale of such equipment and investments have the potential to make the 'Cash from Operations' figure positive.

Required:

Discuss the ethical responsibility of Spinz Ltd.'s Chartered Accountant who is an employee to ensure that the manipulation of the Statement of Cash Flows, as suggested by the directors, does not occur.

Solution

In order to meet targets, it is quite possible that management may want to **present a company's results in a favourable manner**. Such an objective could be achieved by employing creative accounting techniques such as window dressing, or as can be seen in the case, **inaccurate classification**.

As per para 16 of Ind AS 7, separate disclosure of cash flows arising from investing activities is important because the cash flows represent the extent to which expenditures have been made for resources intended to generate future income and cash flows. Only expenditures that result in a recognized asset in the balance sheet are eligible for classification as investing activities. Example of cash flows arising from investing activities are cash receipts from sales of property, plant and equipment, intangibles and other long-term assets.

Presenting proceeds of sale of investments and under-utilized equipment as part of 'Cash from Operations' gives a **misleading picture** of the financial statements. Operating cash flows are crucial for the long-term survival of the company, and a negative cash from operations figure could be a possible indicator of cash shortage in the short-term, and possibly question the going concern assumption of the entity in the long-run. Further, operating cash flows are recurring, whereas investing and financing cash flows tend to be one-off.

In the given case, it may appear that to meet cash requirements for its operations, the company is selling its investments and equipment. Selling of equipment and investments is not usually a part of trading operations. Such sales generate short-term cash flow and cannot be repeated on a regular basis. The proposed misclassification could be regarded as a deliberate attempt to mislead stakeholders about the performance of Spinz Ltd. and its future performance, which is unethical.

Chartered Accountants have a duty, not only to the **company** they work for, but also to their **professional body (i.e., ICAI)**, and to the **stakeholders** of the company. Proceeds received from sale of equipment and investment should be presented under **'Cash Flows from Investing Activities'** (instead of 'Operating Activities') in accordance with Ind AS 7, Statement of Cash Flows. As per the Code of Ethics, a Chartered Accountant should follow the fundamental principle of

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professional competence and due care which includes preparing financial statements in compliance with Ind AS. In case the accountant permits the treatment of the matter as proposed by the management, it would result in a breach of the principle of professional competence and due care. This treatment may be permitted by the accountant under pressure from the management.

The chartered accountant should **prevent the management not to proceed with the aforesaid accounting treatment** which violates Ind AS 7. In case the management insists on continuing with their suggested treatment, then the chartered accountant must **bring this to the attention of the auditors**. Otherwise, the chartered accountant would be subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949. The Clause 1 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

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Illustration 7:

Infostar Ltd. is a listed company engaged in the provision of IT services in India. The directors are paid a bonus based on the profits achieved by the company during the year as per the bonus table given below:

Profit Range	***Bonus to Directors***
NIL < Profit < ₹ 1 crore	*NIL*
₹ 1 crore < Profit < ₹ 5 crores	*2% of Net Profit*
₹ 5 crores < Profit < ₹ 10 crores	*4% of Net Profit*
₹ 10 crores < Profit < ₹ 20 crores	*6% of Net Profit*
₹ 20 crores < Profit < ₹ 30 crores	*8% of Net Profit*
Profit > ₹ 30 crores	*10% of Net Profit*

The draft Statement of Profit and Loss for the year ended 31 March 20X2 currently shows a profit of ₹ 2 crores.

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Issue:

The employees of Infostar Ltd. have historically been paid an individual-performance-based discretionary incentive for the last 15 years. Based on the past trends and performance, the bonus amount for the year 20X1-20X2 would be ₹ 3 crores. In view of the possibility of the directors not receiving the bonus on account of the company's poor performance, Infostar Ltd.'s Chief Financial Officer (CFO), who is a chartered accountant, has suggested that the discretionary incentive usually payable to the employees could be avoided in the current year, which would result in the company reporting profits. As a part of its annual report, Infostar Ltd. reports employee satisfaction scores, staff attrition rates, gender equality and employee absenteeism rates as non-financial performance measures. The CFO has also told the directors over mail that no stakeholder reads the non-financial information anyway, and thus his aforesaid suggestion of not paying the discretionary incentive would not impact the company greatly.

Required:

Discuss the ethical and accounting implications of the above issues, referring to the relevant Ind AS wherever appropriate from perspective of CA. Sushil Bhupathy.

Solution

Ethical Considerations

Long-term success of any organization strongly depends on the fair treatment of employees, which in turn is based on the ethical behaviour of the management as well as how the same is perceived by the stakeholders. In the given case, the CFO has suggested not paying the discretionary bonus, which the directors are considering as it will enable the company to record profits of ₹ 2 crores, thereby ensuring a bonus pay out to the directors. This suggestion is not illegal at all as the bonus is discretionary rather than statutory/contractual. In other words, the company has no legal obligation to pay the bonus to the employees. However, the reason behind non-payment of the bonus is what gives rise to ethical considerations. The suggestion by the CFO will have the aforesaid impact of reducing expenses and improving profits.

On a moral ground, the suggestion is likely to have negative consequences for the company. The employees would be dissatisfied that the bonus has been withdrawn, and further, when they would see the directors withdrawing bonuses out of the profits arising on a saving in bonus costs, it would have a negative impact on employee morale, which would result in low employee satisfaction scores and poor retention rates, which are reported as non-financial information in the financial statements. Companies are also under increasing pressure to reduce the wage gap between the management and its employees. By not paying a bonus, this metric will be adversely affected.

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The CFO's statement that the above action will not negatively impact the company as the non-financial reporting indicators are not widely read by the users is misleading. The non-financial information is becoming increasingly important to the users of financial statements as they care about companies' treatment of their employees and view it as being important in the long-term success of the company.

A chartered accountant has a responsibility to exercise due diligence and clearly consider both financial and non-financial information while discharging his professional duty. It would be unethical for a chartered accountant to guide the management on matters which may result into any kind of disadvantage (it includes even non-financial matters) to the stakeholders.

Further, a distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. A chartered accountant's responsibility is not exclusively to satisfy the needs of an individual client or employing organization. Therefore, the Code contains requirements and application material to enable chartered accountants to meet their responsibility to act in the public interest. *(Refer Section 100.1 A1, Code of Ethics issued by ICAI)*

Hence, it is essential for a chartered accountant to uphold the professional standards and act in accordance with the ethical principles by ensuring transparency and accuracy in financial reporting.

*****

E. INDUCEMENTS, INCLUDING GIFTS AND HOSPITALITY

An inducement is an object, situation, or action that is used as a means to influence another individual's behaviour, but not necessarily with the intent to improperly influence that individual's behaviour. Inducements can range from minor acts of hospitality between business colleagues to acts that result in non-compliance with laws and regulations. An inducement can take many different forms, for example:

- Gifts.
- Hospitality.
- Entertainment.
- Political or charitable donations.
- Appeals to friendship and loyalty.
- Employment or other commercial opportunities.
- Preferential treatment, rights or privileges

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1. Immediate or Close Family Members

A Chartered Accountant shall remain alert to potential threats to the accountant's compliance with the fundamental principles created by the offering of an inducement:

(a) By an immediate or close family member of the accountant to a counterparty with whom the accountant has a professional relationship; or

(b) To an immediate or close family member of the accountant by a counterparty with whom the accountant has a professional relationship.

Where the Chartered Accountant becomes aware of an inducement being offered to or made by an immediate or close family member and concludes there is intent to improperly influence the behaviour of the accountant or of the counterparty or considers a reasonable and informed third party would be likely to conclude such intent exists, the accountant shall advise the immediate or close family member not to offer or accept the inducement.

One of the factors that is relevant in determining whether there is actual or perceived intent to improperly influence the behaviour of the Chartered Accountant or of the counterparty is the nature or closeness of the relationship, between:

(a) The accountant and the immediate or close family member;

(b) The immediate or close family member and the counterparty; and

(c) The accountant and the counterparty.

For example, the offer of employment, outside of the normal recruitment process, to the spouse of the accountant by a counterparty with whom the accountant is negotiating a significant contract might indicate such intent.

F. RESPONDING TO NON-COMPLIANCE WITH LAWS AND REGULATIONS IN CASE OF EMPLOYMENT WITH LISTED ENTITIES

A Chartered Accountant might encounter or be made aware of non-compliance or suspected non-compliance in the course of carrying out professional activities. This section guides the accountant in assessing the implications of the matter and the possible courses of action when responding to non-compliance or suspected non-compliance with:

(a) Laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the employing organization's financial statements; and

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(b) Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the employing organization's financial statements, but compliance with which might be fundamental to the operating aspects of the employing organization's business, to its ability to continue its business, or to avoid material penalties.

A distinguishing mark of the accountancy profession is its acceptance of the responsibility to act in the public interest. When responding to non-compliance or suspected non-compliance, the objectives of the Chartered Accountant are:

(a) To comply with the principles of integrity and professional behaviour;

(b) By alerting management or, where appropriate, those charged with governance of the employing organization, to seek to:

(i) Enable them to rectify, remediate or mitigate the consequences of the identified or suspected non-compliance; or

(ii) Deter the non-compliance where it has not yet occurred; and

(c) To take such further action as appropriate in the public interest.

Non-compliance with laws and regulations ("non-compliance") comprises acts of omission or commission, intentional or unintentional, which are contrary to the prevailing laws or regulations committed by the following parties:

(a) The Chartered Accountant's employing organization;

(b) Those charged with governance of the employing organization;

(c) Management of the employing organization; or

(d) Other individuals working for or under the direction of the employing organization.

Examples of laws and regulations which this section addresses include those that deal with:

- Fraud, corruption and bribery.
- Money laundering, terrorist financing and proceeds of crime.
- Securities markets and trading.
- Banking and other financial products and services.
- Data protection.
- Tax and pension liabilities and payments.

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- Environmental protection.
- Public health and safety.

1. Responsibilities of All Chartered Accountants

If protocols and procedures exist within the Chartered Accountant's employing organization to address non-compliance or suspected non-compliance, the accountant shall consider them in determining how to respond to such non-compliance.

2. Responsibilities of Chartered Accountant being a Key Managerial Personnel in Service

Chartered accountants being key managerial personnel in service are directors, officers or senior employees able to exert significant influence over and make decisions regarding, the acquisition, deployment and control of the employing organization's human, financial, technological, physical and intangible resources. There is a greater expectation for such individuals to take whatever action is appropriate in the public interest to respond to non-compliance or suspected non-compliance than other chartered accountants within the employing organization.

Obtaining an Understanding of the Matter

If, in the course of carrying out professional activities, a chartered accountant being a key managerial personnel in service becomes aware of information concerning non-compliance or suspected non-compliance, the accountant shall obtain an understanding of the matter. This understanding shall include:

(a) The nature of the non-compliance or suspected non-compliance and the circumstances in which it has occurred or might occur;

(b) The application of the relevant laws and regulations to the circumstances; and

(c) An assessment of the potential consequences to the employing organization, investors, creditors, employees or the wider public.

A chartered accountant being a key managerial personnel in service is expected to apply knowledge and expertise and exercise professional judgment. However, the accountant is not expected to have a level of understanding of laws and regulations greater than that which is required for the accountant's role within the employing organization. Whether an act constitutes non-compliance is ultimately a matter to be determined by a court or other appropriate adjudicative body.

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Depending on the nature and significance of the matter, the chartered accountant being a key managerial personnel in service might cause, or take appropriate steps to cause, the matter to be investigated internally. The accountant might also consult on a confidential basis with others within the employing organization or Institute, or with legal counsel.

Addressing the Matter

If the chartered accountant being a key managerial personnel in service, identifies or suspects that non-compliance has occurred or might occur, the accountant shall, discuss the matter with the accountant's immediate superior, if any. If the accountant's immediate superior appears to be involved in the matter, the accountant shall discuss the matter with the next higher level of authority within the employing organization.

The chartered accountant being a key managerial personnel in service shall also take appropriate steps to:

(a) Have the matter communicated to those charged with governance;

(b) Comply with applicable laws and regulations, including legal or regulatory provisions governing the reporting of non-compliance or suspected non-compliance to an appropriate authority;

(c) Have the consequences of the non-compliance or suspected non-compliance rectified, remediated or mitigated;

(d) Reduce the risk of re-occurrence; and

(e) Seek to deter the commission of the non-compliance if it has not yet occurred.

The purpose of communicating the matter to those charged with governance is to obtain their concurrence regarding appropriate actions to take to respond to the matter and to enable them to fulfill their responsibilities.

In addition to responding to the matter in accordance with the provisions of this section, the chartered accountant being a key managerial personnel in service shall determine whether disclosure of the matter to the employing organization's external auditor, if any, is needed.

Such disclosure would be pursuant to the duty or legal obligation of the chartered accountant being a key managerial personnel in service to provide all information necessary to enable the auditor to perform the audit.

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Determining whether further action is needed

The chartered accountant being a key managerial personnel in service shall assess the appropriateness of the response of the accountant's superiors, if any, and those charged with governance.

Relevant factors to consider in assessing the appropriateness of the response of the superiors of chartered accountant being a key managerial personnel in service if any, and those charged with governance include whether:

- ***The response is timely.***
- ***They have taken or authorized appropriate action to seek to rectify, remediate or mitigate the consequences of the non-compliance, or to avert the non-compliance if it has not yet occurred.***
- ***The matter has been disclosed to an appropriate authority where appropriate and, if so, whether the disclosure appears adequate.***

In light of the response of the superiors of chartered accountant being a key managerial personnel in service, if any, and those charged with governance, the accountant shall determine if further action is needed in the public interest. The determination of whether further action is needed, and the nature and extent of it, will depend on various factors, including:

- ***The legal and regulatory framework.***
- ***The urgency of the situation.***
- ***The pervasiveness of the matter throughout the employing organization.***
- ***Whether the chartered accountant being a key managerial personnel in service continues to have confidence in the integrity of the accountant's superiors and those charged with governance.***
- ***Whether the non-compliance or suspected noncompliance is likely to recur.***
- ***Whether there is credible evidence of actual or potential substantial harm to the interests of the employing organization, investors, creditors, employees or the general public.***

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Examples of circumstances that might cause the chartered accountant being a key managerial personnel in service no longer to have confidence in the integrity of the accountant's superiors and those charged with governance include situations where:

- *The accountant suspects or has evidence of their involvement or intended involvement in any non-compliance.*
- *Contrary to legal or regulatory requirements, they have not reported, or authorized the reporting of, the matter to an appropriate authority within a reasonable period.*

The chartered accountant being a key managerial personnel in service shall exercise professional judgment in determining the need for, and nature and extent of, further action. In making this determination, the accountant shall take into account whether a reasonable and informed third party would be likely to conclude that the accountant has acted appropriately in the public interest.

Further action that the chartered accountant being a key managerial personnel in service might take includes:

- *Informing the management of the parent entity of the matter if the employing organization is a member of a group.*
- *Disclosing the matter to an appropriate authority as specified under respective law.*
- *Resigning from the employing organization.*

Resigning from the employing organization is not a substitute for taking other actions that might be needed to achieve the objectives of chartered accountant being a key managerial personnel in service under this section. However, there might be limitations as to the further actions available to the accountant. In such circumstances, resignation might be the only available course of action.

Seeking advice

As assessment of the matter might involve complex analysis and judgments, the chartered accountant being a key managerial personnel in service, might consider:

- *Consulting internally.*
- *Obtaining legal advice to understand the accountant's options and the professional or legal implications of taking any particular course of action.*
- *Consulting on a confidential basis with the Institute.*

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Determining whether to disclose the matter to an appropriate authority

Disclosure of the matter to an appropriate authority would be precluded if doing so would be contrary to law or regulation.

Otherwise, the purpose of making disclosure is to enable an appropriate authority to cause the matter to be investigated and action to be taken in the public interest.

The determination of whether to make such a disclosure depends in particular on the nature and extent of the actual or potential harm that is or might be caused by the matter to investors, creditors, employees or the general public. For example, the chartered accountant being a key managerial personnel in service might determine that disclosure of the matter to an appropriate authority is an appropriate course of action if:

- ***The employing organization is engaged in bribery (for example, of local or foreign government officials for purposes of securing large contracts).***
- ***The employing organization is regulated and the matter is of such significance as to threaten its license to operate.***
- ***The employing organization is listed on a securities exchange and the matter might result in adverse consequences to the fair and orderly market in the employing organization's securities or pose a systemic risk to the financial markets.***
- ***It is likely that the employing organization would sell products that are harmful to public health or safety.***
- ***The employing organization is promoting a scheme to its clients to assist them in evading taxes.***

The determination of whether to make such a disclosure will also depend on external factors such as:

- ***Whether there is an appropriate authority that is able to receive the information and cause the matter to be investigated and action to be taken. For example, the appropriate authority would be the Institute in case of complaint of professional misconduct against a chartered accountant, whether in practice or in service, Securities and Exchange Board of India (SEBI) in the case of fraudulent financial reporting or an environmental protection agency, e.g. Environment Pollution (Prevention & Control) Authority for National Capital Region of Delhi in the case of a breach of environmental laws and regulations.***

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- *Whether there exists robust and credible protection from civil, criminal or professional liability or retaliation afforded by legislation or regulation, such as under whistle-blowing legislation or regulation.*
- *Whether there are actual or potential threats to the physical safety of the chartered accountant being a key managerial personnel in service or other individuals.*

If the chartered accountant being a key managerial personnel in service determines that disclosure of the matter to an appropriate authority, if required, is an appropriate course of action in the circumstances, that disclosure is permitted. When making such disclosure, the accountant shall act in good faith and exercise caution when making statements and assertions.

Imminent breach

In exceptional circumstances, the chartered accountant being a key managerial personnel in service might become aware of actual or intended conduct that the accountant has reason to believe would constitute an imminent breach of a law or regulation that would cause substantial harm to investors, creditors, employees or the general public. Having first considered whether it would be appropriate to discuss the matter with management or those charged with governance of the employing organization, the accountant shall exercise professional judgment and determine whether to disclose the matter immediately to an appropriate authority in order to prevent or mitigate the consequences of such imminent breach.

Documentation

In relation to non-compliance or suspected non-compliance that falls within the scope of this section, the chartered accountant being a key managerial personnel in service is encouraged to have the following matters documented:

- *The matter.*
- *The results of discussions with the accountant's superiors, if any, and those charged with governance and other parties.*
- *How the accountant's superiors, if any, and those charged with governance have responded to the matter.*
- *The courses of action the accountant considered, the judgments made and the decisions that were taken.*
- *How the accountant is satisfied that the accountant has fulfilled the responsibility set out in paragraph R260.17.*

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Illustration 8:

Agastya Ltd. is a listed company engaged in the manufacturing of automotive spare parts. The company is preparing the financial statements for the year ended 31 March 20X3. The directors of Agastya Ltd. are entitled to an incentive based on the operating profit margin of the company. You have been appointed as a consultant to advise on the preparation of the financial statements, and you notice the following issue:

Issue:

The draft financial statements include an amount of ₹ 75 lakhs given as loan to a director. The loan has no specific repayment terms; the same is repayable on demand. The directors have included such loan under the heading 'Cash and Cash Equivalents'. They have reasoned that since such loan, which is advanced to one of the directors, is repayable on demand, it is readily convertible to cash. Further the directors opine that such presentation should not be a problem even under the Ind AS Framework as financial statements are essentially prepared in accordance with accounting policies which is the choice of the company, and in this case, Agastya Ltd. has made a policy choice to show such loan as a cash equivalent.

Required:

Discuss the ethical and accounting implications of the above issues, referring to the relevant Ind AS wherever appropriate.

Solution

The directors have included a loan made to a director as a part of Cash and Cash Equivalents. It appears that the directors have misunderstood the definition of Cash and Cash Equivalents, believing the loan to be a cash equivalent. As per Ind AS 7, *Statement of Cash Flows*, cash equivalents are short-term, highly liquid investments readily convertible to known amounts of cash and which are subject to insignificant risk of changes in value. However, the loan given to the directors is not in place to enable Agastya Ltd. to manage its short-term cash commitments, it has no fixed repayment date and the likelihood of the director defaulting is also not known. Thus, the classification as a cash equivalent is inappropriate.

Instead, the loan should be regarded as a financial asset under Ind AS 109, *Financial Instruments*. Further information would be required, for example is ₹ 75 lakhs fair value? It could be said that the loan will never be repaid, and accordingly could be regarded as a component of directors' remuneration, and if so, the same should be expensed and disclosed accordingly. Further, since

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the director is likely to fall into the category of key management personnel, related party disclosures under Ind AS 24, *Related Party Disclosures* are likely to be necessary.

The treatment of loan as a cash equivalent breached two fundamental qualitative characteristics prescribed in the Conceptual Framework for Financial Reporting, namely:

(i) Relevance: The information should be disclosed separately as it is relevant to users.

(ii) Faithful representation: Information must be complete, neutral and free from error. Clearly, this will not be the case if loan to a director is shown as Cash Equivalents

The said treatment is also violative of the Conceptual Framework's key enhancing qualitative characteristics:

(i) **Understandability:** if the loan is shown as Cash Equivalents, it masks the true nature of company's practices, thereby reducing the understandability of the financial statements to the users.

(ii) **Verifiability:** Verifiability ensures that different knowledgeable and independent observers can reach consensus that a particular depiction of a transaction / account balance is a faithful representation. Verifiability gives assurance to the users that the information faithfully represents the economic phenomena it intends to represent. The treatment given by the directors of Agastya Ltd. does not meet this benchmark as it reflects the subjective bias of the directors.

(iii) **Comparability:** For financial statements to be comparable year-on-year and with other companies, transactions must be correctly classified and presented, which is not happening here. If the cash balance of one year includes a loan to a director and the next year it does not, then you are not comparing like with like.

There is a potential **conflict of interest** between that of the director and that of the company, which mandates a separate disclosure as a minimum. Further, issues with compliance of section 185 of the Companies Act, 2013 would arise, which is why probably the directors want to hide such loan balance under cash equivalents. Directors are responsible for the financial statements required by statute, and thus it is their responsibility to put right any errors that result in the financial statements not complying with Ind AS. The directors are also legally bound to maintain proper accounting records and recording a loan as cash equivalent clashes with this requirement.

By masking the nature of the transaction, it is possible that the directors are **motivated by personal interest** and are thus failing in their duty to act honestly and ethically. If one transaction is misleading, it casts doubt on the credibility of the financial statements as a whole.

As a consultant, it becomes his responsibility to get the financial statements rectified and guide the directors about the principles enunciated in Ind AS and the correct treatment in accordance

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with the standards. Otherwise, he will be subject to professional misconduct under Clause 6 and 7 of Part I of Second Schedule of the Chartered Accountants Act, 1949.

Clause 6 of Part I of the Second Schedule of the Chartered Accountants Act 1949 states that a CA is guilty of professional misconduct when he fails to report a material misstatement known to him to appear in a financial statement with which he is concerned in a professional capacity.

The Clause 7, states that a Chartered Accountant is guilty of professional misconduct when he does not exercise due diligence or is grossly negligent in the conduct of his professional duties.

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G. PRESSURE TO BREACH THE FUNDAMENTAL PRINCIPLES

A Chartered Accountant shall not:

(a) Allow pressure from others to result in a breach of compliance with the fundamental principles; or

(b) Place pressure on others that the accountant knows, or has reason to believe, would result in the other individuals breaching the fundamental principles.

A Chartered Accountant might face pressure that creates threats to compliance with the fundamental principles, for example an intimidation threat, when undertaking a professional activity. Pressure might be explicit or implicit and might come from:

- Within the employing organization, for example, from a colleague or superior.
- An external individual or organization such as a vendor, customer or lender.
- Internal or external targets and expectations.

Examples of pressure that might result in threats to compliance with the fundamental principles include:

- Pressure related to conflicts of interest:
    - Pressure from a family member bidding to act as a vendor to the Chartered Accountant's employing organization to select the family member over another prospective vendor.
- ***Pressure to influence preparation or presentation of information:***
    - ***Pressure to report misleading financial results to meet investor, analyst or lender expectations.***

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- *Pressure from elected officials on public sector accountants to misrepresent programs or projects to voters.*
- *Pressure from colleagues to misstate income, expenditure or rates of return to bias decision-making on capital projects and acquisitions.*
- *Pressure from superiors to approve or process expenditures that are not legitimate business expenses.*
- *Pressure to suppress internal audit reports containing adverse findings.*

- *Pressure to act without sufficient expertise or due care:*
  - *Pressure from superiors to inappropriately reduce the extent of work performed.*
  - *Pressure from superiors to perform a task without sufficient skills or training or within unrealistic deadlines.*
- *Pressure related to financial interests:*
  - *Pressure from superiors, colleagues or others, for example, those who might benefit from participation in compensation or incentive arrangements to manipulate performance indicators.*
- *Pressure related to inducements:*
  - *Pressure from others, either internal or external to the employing organization, to offer inducements to influence inappropriately the judgment or decision-making process of an individual or organization.*
  - *Pressure from colleagues to accept a bribe or other inducement, for example to accept inappropriate gifts or entertainment from potential vendors in a bidding process.*
- *Pressure related to non-compliance with laws and regulations:*
  - *Pressure to structure a transaction to evade tax.*
- *Pressure related to level of fees*
  - *Pressure exerted by a chartered accountant on another chartered accountant to provide professional services at a fee level that does not allow for sufficient and appropriate resources (including human, technological and intellectual resources) to perform the services in accordance with technical and professional standards.*

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Factors that are relevant in evaluating the level of threats created by pressure include:

- ***The intent of the individual who is exerting the pressure and the nature and extent of the pressure.***
- ***The application of laws, regulations, and professional standards to the circumstances.***
- ***The culture and leadership of the employing organization including the extent to which they reflect or emphasize the importance of ethical behaviour and the expectation that employees will act ethically. For example, a corporate culture that tolerates unethical behaviour might increase the likelihood that the pressure would result in a threat to compliance with the fundamental principles.***
- ***Policies and procedures, if any, that the employing organization has established, such as ethics or human resources policies that address pressure.***

Discussing the circumstances creating the pressure and consulting with others about those circumstances might assist the Chartered Accountant to evaluate the level of the threat. Such discussion and consultation, which requires being alert to the principle of confidentiality, might include:

- Discussing the matter with the individual who is exerting the pressure to seek to resolve it.
- Discussing the matter with the accountant's superior, if the superior is not the individual exerting the pressure.
- Escalating the matter within the employing organization, including when appropriate, explaining any consequential risks to the organization, for example with:
    - Higher levels of management.
    - Internal or external auditors.
    - Those charged with governance.
- Disclosing the matter in line with the employing organization's policies, including ethics and whistleblowing policies, using any established mechanism, such as a confidential ethics hotline.
- Consulting with:
    - A colleague, superior, human resources personnel, or another Chartered Accountant;
    - Institute or industry associations; or

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- Legal counsel.

An example of an action that might eliminate threats created by pressure is the Chartered Accountant's request for a restructure of, or segregation of, certain responsibilities and duties so that the accountant is no longer involved with the individual or entity exerting the pressure.

The chartered accountant is encouraged to document:

- ***The facts.***
- ***The communications and parties with whom these matters were discussed.***
- ***The courses of action considered.***
- ***How the matter was addressed.***

Illustration 9:

As at 31 March 20X4, Mitra Ltd. had a plan to dispose off its 75% subsidiary Dosti Ltd. This plan had been approved by the board and was reported in the media as well as to the Stock Exchange where Mitra Ltd. was listed. It is expected that Jaya Ltd., the non-controlling shareholder in Dosti Ltd. holding 25% stake, will acquire the 75% equity interest as well. The sale is expected to be completed by October 20X4. Dosti Ltd. is expected to have substantial trading losses in the period up to the sale. Mr. X, a chartered accountant, who is an employee in the finance department of Mitra Ltd., wishes to show Dosti Ltd. as held for sale in the financial statements and to create a restructuring provision to include the expected costs of disposal and future trading losses. However, the Chief Operating Officer (COO) does not wish Dosti Ltd. to be categorized as held for sale nor to provide for the expected losses. The COO is concerned as to how this may affect the sales and would surely result in bonus targets not being met. He has argued that as the management, it is his duty to secure a high sales price to maximize the return for shareholders of Mitra Ltd. He has also hinted that Mr. X's job could be at stake if such a provision were to be made in the financial statements. The expected costs from the sale are as follows:

Future Trading Losses:	*₹ 20 crores*
Various legal costs of sale	*₹ 1.5 crores*
Redundancy costs for Dosti Ltd.'s employees	*₹ 4 crores*
Impairment losses on Property, Plant and Equipment	*₹ 7 crores*

Required:

(a) Discuss the accounting treatment which Mitra Ltd. should adopt to address the issue above for the financial statements.

(b) Discuss the ethical issues which may arise in the above scenario, including any actions which Mitra Ltd. and Mr. X should take.

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Solution

(a) In terms of Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations, an entity shall classify a non-current asset (or disposal group) as held for sale if its carrying amount will be recovered principally through a sale transaction rather than through continuing use.

For this to be the case, the asset (or disposal group) must be available for immediate sale in its present condition subject only to terms that are usual and customary for sales of such assets (or disposal groups) and its sale must be *highly probable*.

For the sale to be highly probable, the appropriate level of management must be committed to a plan to sell the asset (or disposal group), and an active programme to locate a buyer and complete the plan must have been initiated. Further, the asset (or disposal group) must be actively marketed for sale at a price that is reasonable in relation to its current fair value. In addition, the **sale should be expected to qualify for recognition as a completed sale within one year from the date of classification**, except in specific cases as permitted by the Standard, and actions required to complete the plan should indicate that it is unlikely that significant changes to the plan will be made or that the plan will be withdrawn. The probability of required approvals (as per the jurisdiction) should be considered as part of the assessment of whether the sale is highly probable.

An entity that is committed to a sale plan involving loss of control of a subsidiary shall classify all the assets and liabilities of that subsidiary as held for sale when the criteria set out above are met, regardless of whether the entity will retain a non-controlling interest in its former subsidiary after the sale.

Based on the provisions highlighted above, the disposal of Dosti Ltd. appears to meet the criteria of **held for sale**. Jaya Ltd. is the probable acquirer, and the sale is highly probable, expected to be completed seven months after the year end, well within the 12-months criteria highlighted above. Accordingly, Dosti Ltd. should be treated as a disposal group, since a single equity transaction is the most likely form of disposal. In case Dosti Ltd. is deemed to be a separate major component of business or geographical area of the group, the losses of the group should be presented separately as a discontinued operation within the Financial Statements of Mitra Ltd.

In terms of Ind AS 105, Non-current Assets Held for Sale and Discontinued Operations, an entity shall measure a non-current asset (or disposal group) classified as held for sale at the **lower of its carrying amount and fair value less costs to sell**. The carrying amount of Dosti Ltd. (i.e., the subsidiary of Mitra Ltd.) comprises of the net assets and goodwill less the non-controlling interest. The impairment loss recognised to reduce Dosti Ltd. to fair

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value less costs to sell should be allocated first to goodwill and then on a pro-rata basis across the other non-current assets of the Company.

The Chief Operating Officer (COO) is incorrect to exclude any form of restructuring provision in the Financial Statements. Since the disposal is communicated to the media as well as the Stock Exchange, a constructive obligation exists. However, ongoing costs of business should not be provided for, only **directly attributable costs of restructuring** should be provided. Future operating losses should be excluded as no obligating event has arisen, and no provision is required for impairment losses of Property, Plant and Equipment as it is already considered in the remeasurement to fair value less costs to sell. Thus, a provision is required for ₹ 5.5 crores (₹ 1.5 crores + ₹ 4 crores).

(b) **Ethics**

Accountants have a duty to ensure that the financial statements are **fair**, **transparent** and **comply with the accounting standards**. Mr. X have committed several mistakes. In particular, he was unaware of which costs should be included within a restructuring provision and has failed to recognise that there is no obligating event in relation to future operating losses. A chartered accountant is expected to carry his work with **due care and attention** for lending credibility to the financial statements. Accordingly, he must update his knowledge and ensure that work is carried out in accordance with relevant ethical and professional standards. Failure to do so would be a breach of **professional competence**. Accordingly, Mr. X must ensure that this issue is addressed, for example by attending regular training and professional development courses.

It appears that the chief operating officer is looking for means to **manipulate** the financial statements for meeting the bonus targets. Neither is he is willing to reduce the profits of the group by applying held for sale criteria in respect of Dosti Ltd. nor is he willing to create appropriate restructuring provisions. Both the adjustment which comply with the requirements of Ind AS will result in reduction of profits. His argument that the management has a duty to maximize the returns for the shareholders is true, but such maximization must not be achieved at the cost of **objective** and **faithful representation** of the performance of the Company. In the given case, it appears that the chief operating officer is motivated by bonus targets under the garb of maximizing returns for the shareholders, thereby resulting in misrepresentation of the results of the group.

Further, by threatening to dismiss Mr. X, the COO has acted unethically. **Threatening and intimidating behaviour** is unacceptable and against all ethical principles. This has given rise to an **ethical dilemma** for Mr. X. He has a duty to produce financial statements but doing so in a fair manner could result in a loss of job for him. The chartered accountant should approach the chief operating officer and remind him the basic ethical principles and

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communicate him to do the necessary adjustments in the accounts so that they are fair and objective.

In case Mr. X, falls under undue influence of COO and applies the incorrect accounting treatment, he will be subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949. The Clause 1 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, for contravening the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

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TEST YOUR KNOWLEDGE

Question

1. Shastra Ltd. desires to upgrade its production process since the directors believe that technology-led production is the only way the company can remain competitive. On 1 April 20X5, the company entered into a property lease arrangement in order to obtain tax benefits. However, the draft financial statements do not show a lease asset or a lease liability as on date.

   A new financial controller, CA. Sunil Raghavan, joined Shastra Ltd. before the financial year ending 31 March 20X6 and was engaged in the review of financial statements to prepare for the upcoming audit and to begin making a loan application to finance the new technology. CA. Sunil Raghavan believes that the lease arrangement should be recognized in the Balance Sheet. However, the Managing Director, Ms. Anusha Shrivastava, an MBA (Finance), strongly disagrees. She wishes to charge the lease rentals to the Statement of Profit or Loss. Her opinion is based on the understanding that the lease arrangement is merely a monthly rental payment, without any corresponding asset or obligation, since there is no 'invoice' for transfer of asset to Shastra Ltd. Her disagreement also stems from the fact that showing a lease obligation in the Financial Statements would impact the gearing ratio of the company, which could have an adverse impact on the upcoming loan application. Ms. Anusha has made it clear to CA. Sunil Raghavan that at stake is not only the loan application but also his future prospects at Shastra Ltd.

   Discuss the potential ethical conflicts which may arise in the above scenario and the ethical principles which would guide how the financial controller should respond to the situation.

2. Astra Ltd. is a listed entity which operates in the defence and fibre optics sector. It supplies fibre optic cables and racks in the domestic country. This activity is only a trading activity for Astra Ltd. as it procures goods from pre-approved suppliers, and after inspection, sells the goods to IT companies. The sale contract requires Astra Ltd. to deliver these goods to the IT companies' locations (i.e., delivery on site). Payment terms are 30 days after the invoice date to Astra Ltd.

   Ms. Suparna Dasgupta, a chartered accountant, has recently joined Astra Ltd. as the Head of the Finance Department.

   The Chief Operating Officer (also the executive director) of Astra Ltd. is Ms. Padmaja Srinivasan, a mechanical engineer with an MBA from Harvard University, who rose through

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the ranks through her excellent skills in project management, marketing, and customer management. Her remuneration includes a bonus computed as a percentage of turnover achieved during the year, and an additional incentive for achieving an EBITDA in excess of 15% of turnover.

Astra Ltd. has sold fibre optic cables amounting to ₹ 2 crores (invoice dated 31st March 20X2) to Ethernet Bullet Ltd., a company providing high-speed internet connectivity services through fibre optic cables as well as dedicated leased lines. The service unit of Ethernet Bullet Ltd. is located next to the factory of Astra Ltd. Though the goods were not moved to Ethernet Bullet Ltd.'s service unit, Astra Ltd. recognized the sale for the year, based on the contention that the service unit is adjacent, and hence the transfer can happen within a few minutes.

The annual results are due for board approval, for the year ending 31st March, and require the sign-off of Ms. Suparna Dasgupta.

Ms. Suparna Dasgupta has been given a 40% increment on joining Astra Ltd., which enables her to comfortably pay off her housing loan mortgage every month. Additionally, she is also given perquisites in the form of business class travel, an exclusive chauffeur-driven car and stock options of the company. Accordingly, she has stated that she cannot afford to lose this job as the salary and perquisites are among the best in the country.

Ms. Padmaja Srinivasan has communicated to Ms. Suparna Dasgupta that many more benefits will accrue if she agrees to present the numbers without any modifications. She has also said that the company would not hesitate to replace Ms. Suparna Dasgupta should she disagree with the contentions above.

Discuss the potential conflicts which are arising in the above scenario and the ethical principles that would guide Ms. Suparna Dasgupta in responding to the situation.

3. Sunshine Ltd., a listed company in the cosmetics industry, has debt covenants attached to some of its borrowings which are included in Financial Liabilities in the Balance Sheet. These covenants mandate the company to repay the debt in full if Sunshine Ltd. fails to maintain a liquidity ratio and operating margin above the specified limit.

The directors alongwith the CFO of the Company who is a chartered accountant are considering entering into a fresh five-year leasing arrangement but are concerned about the negative impact any potential lease obligations may have on the above-mentioned covenants. Accordingly, the directors and CFO propose that the lease agreement be drafted in such a way that it is a series of six ten-month leases rather than a single five-year lease in order to utilize the short-term lease exemption available under Ind AS 116, Leases. This would then

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enable accounting for the leases in their legal form. The directors believe that this treatment will meet the requirements of the debt covenant, though such treatment may be contrary to the accounting standards.

Discuss the ethical and accounting implications of the above issue from the perspective of CFO.

4. Zenith Infrastructure Ltd. is engaged in the construction of large commercial complexes. During the financial year ending 31 March 20X6, the company undertook a major project which experienced significant delays due to regulatory approvals and design changes. As a result, the management expects the project to incur substantial additional costs, which may lead to a loss on the contract.

While reviewing the draft financial statements, the Finance Manager, CA. Neha Kapoor, noted that no provision has been made for the expected loss on the contract, even though reliable estimates of the additional costs are available. In her opinion, in accordance with Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets', the company should recognise a provision for the onerous contract in the financial statements.

However, the Chief Executive Officer, Mr. Arvind Malhotra, advised CA. Neha Kapoor not to recognise the provision in the current year and instead defer it to the next financial year. He believes that recognising the provision would significantly reduce the company's reported profits and may adversely affect the company's ability to secure new infrastructure contracts and maintain its credit rating with lenders. He further indicated that the financial statements should present a "strong performance" for the year.

CA. Neha Kapoor is concerned that not recognising the provision would result in the financial statements not reflecting the true and fair view of the company's financial position and performance.

Discuss the ethical issues and potential conflicts that arise in the above situation. Also explain the fundamental principles of professional ethics that should guide CA. Neha Kapoor in dealing with the matter.

5. Ayush Ltd. is engaged in manufacturing of Solar Panels. Due to current changes in Government policies regarding solar energy, directors expect a huge demand for solar panels. Ayush Ltd.'s directors feel that their current production plant needs up-gradation to increase the production capacity to meet the up-coming huge demand.

The Company needs a significant amount of capital to upgrade the production plant. The current lending policies of the banks require prospective borrowers to demonstrate strong projected cash flows. However, Ayush Ltd.'s current projected statement of cash flow does not satisfy the bank's criteria for lending.

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The directors of Ayush Ltd. have told the lending bank that the company is in an excellent financial position and cash flow projections will meet the bank criteria for lending.

Ayush Ltd.'s draft financial statements include an amount of ₹ 2 crore, which was given as loan to one of its directors. The said loan has no specific repayment terms, but the same loan is repayable on demand.

Directors of Ayush Ltd. forced CA Suraj, an employee of the company, to submit the projected statements of cash flows after including director's loan of ₹ 2 crore under the head 'Cash and Cash Equivalent' instead of showing it as loan under financial asset, as the said loan is repayable on demand. By presenting director's loan in such a way, the cash flow projections will meet the bank's criteria of lending.

Required

(i) Discuss the ethical and accounting implications of the above presentation from the perspective of CA Suraj; and

(ii) Also, discuss the ethical principles which would guide how the Chartered Accountant should respond to the situation.

Answer

1. As per Ind AS 116 'Leases', at the inception of a contract, an entity shall assess whether the contract is, or contains, a lease. A contract is, or contains, a lease if the contract conveys the right to control the use of an identified asset for a period of time in exchange for consideration.

In accordance with the above definition, Shastra Ltd. must recognise a right-of-use asset representing the property and a corresponding lease liability for the obligation to make lease payments. At the commencement date, the right-of-use asset so recognised would include:

- The amount of the initial measurement of lease liability;
- Any lease payments or incentives received before the start date;
- Any initial direct costs;
- Any costs to be incurred for dismantling or removing the underlying asset or restoring the site at the end of the lease term.

The liability for the lease obligation would be measured as the present value of future lease payments including payments that would be made towards any residual value guarantee,

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discounted using the rate implicit in the lease or the incremental rate of borrowing of the lessor, whichever is available.

The fact that there is no 'invoice' evidencing transfer of the asset cannot be a reason to avoid recognition of the right-of-use asset. In fact, what is being recognised is not an asset, since ownership rights are not transferred. What is sought to be recognised under Ind AS 116 is the right to use the asset in the manner required by the lessee Shastra Ltd. Further, since the lease represents an obligation to pay lease rentals in the future, a corresponding lease liability should be recognised. Not recognising the right-of-use asset or lease liability would not only be a violation of Ind AS 116 'Leases', but would also be an incorrect presentation of the financial position, which is critical given that Shastra Ltd. is interested in taking a loan for its operations.

Ethical issues:

The managing director's threat to the financial controller results in an ethical dilemma for the financial controller. This pressure is greater because the financial controller is new.

Threats to fundamental principles

The fact that the position of the financial controller has been threatened if the treatment suggested by the managing director is not followed indicates that there is an **intimidation threat** to the fundamental principles of **objectivity** and **integrity**.

Further, as the managing director has flagged the risk that the company may not obtain loan financing if the lease obligation is recorded in the balance sheet, there is an **advocacy threat** because the financial controller may be compelled to follow an incorrect treatment to maximise the chances of obtaining the loan. This pressure again is greater because the financial controller is new.

Professional competence

When preparing the financial statements, the financial controller should ensure that the fundamental principle of **professional competence** should be followed, which requires that accounts should be prepared in **compliance with Ind AS**.

Thus, since the arrangement meets the Ind AS 116 criteria for a lease, the right-of-use asset and a corresponding lease liability should be recognised, as otherwise the liabilities of Shastra Ltd. would be understated. The ICAI Code of Ethics and Conduct sets boundaries beyond which accountants should not act. If the managing director refuses application of

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Ind AS 116 'Leases', the financial controller should **disclose this to the appropriate internal governance authority**, and thus feel confident that his actions were ethical.

If the financial controller were to bend under pressure and **accept the managing director's proposed treatment**, this would contravene Ind AS 116 and **breach the fundamental principle of professional competence**. In such a case, he would be subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949, which states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

2. Presentation of Revenue numbers:

Ind AS 115 'Revenue from Contracts with Customers' requires revenue to be recognized only on satisfaction of the performance obligations under the contract. It is crucial that the performance obligations be identified at the commencement of the contract, so that the trigger points for revenue recognition become identifiable.

Management would always have an incentive to present higher revenue numbers. In the given case, the fact that the COO is given an incentive for revenues and EBITDA indicates that revenue is a potential area for material misstatement, given the personal interest of the COO in the same.

The sale of fibre optic cable cannot be recognized on 31st March 20X2 as the goods are not yet transferred to the customer Ethernet Bullet Ltd.'s factory premises, which is one of the critical obligations of Astra Ltd. The contention of the COO that it takes merely a few minutes to shift the goods, and hence the sale can be recognized does not hold true. One can always cross-question as to why the movement of goods did not happen if it was merely a few minutes job. It could be a possibility that the goods may not be packed, or there may still be some pending inspection of the goods before transferring the same etc. In view of this, the performance obligation under this contract has not been completed, and hence booking the revenue has resulted in an overstatement of revenue by ₹ 2 crores, and a consequent inflation of profits, assuming that Astra Ltd. is making profit on this sale transaction. Additionally, booking this sale has resulted in an understatement of inventory as at the reporting date of 31st March 20X2.

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In view of the above, multiple conflicts of interest arise for Ms. Suparna Dasgupta:

(a) Pressure to present favourable revenue figures and chartered accountant's personal circumstances

The chartered accountant is under pressure to present favourable numbers, notably in favour of the COO, thereby increasing the incentives to the COO, and in turn benefiting with the continued job prospects. Thus, the ethical and professional standards required of the accountant are at odds with the pressures of her personal circumstances.

(b) Duty to stakeholders

The directors have a duty to act in the best interests of the company's stakeholders. While higher revenue numbers do indicate a good growth trajectory of the company, recognizing the revenue before fulfilling the performance obligations, or incorrectly booking grant income as revenue, results in misleading the stakeholders about the actual performance of the entity, thereby actually becoming detrimental to the stakeholders.

Ethical principles guiding the chartered accountant's response

By exhibiting bias in reporting higher revenue figures due to the risk of losing the job, objectivity stands compromised. Knowingly disclosing incorrect information compromises integrity, and erring in complying with Ind AS requirements, though continuing to report so in the financial statements, results in displaying absence of professional competence.

Appropriate action

In the given case, the chartered accountant faces an ethical dilemma and must apply her moral and ethical judgment. As a professional, she is responsible for presenting the truth, and to avoid indulging in 'creative accounting practices' due to pressure.

The chartered accountant accordingly must put the interests of the company and professional ethics first and insist that the financial statements represent correct revenue numbers, in compliance with the relevant Ind AS. Being an advisor to the directors, she must prevent deliberate misrepresentation / fraudulent financial reporting, regardless of the personal consequences. The accountant should not allow any undue influence from the directors to override her professional judgment or integrity. This is in the long-term interests of the company,

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Further, knowingly providing incorrect information is regarded as professional misconduct. To prevent such misconduct, the chartered accountant should not sign off on the financial statements containing incorrect financial information. By adhering to the ethical principles, the chartered accountant will maintain her professional integrity and contribute to the trust and reliability placed in the work expected from her.

However, if she signs the financial statements containing the inflated revenue numbers, Ms. Suparna Dasgupta would be guilty of professional misconduct under Clause I of Part II of Second Schedule to the Chartered Accountants Act, 1949. The Clause states that a member of the Institute, whether in practice or not, shall be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made thereunder, or any guidelines issued by the Council. As per the Council guidelines, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

3. Stakeholders make informed and accurate decisions based on the information presented in the financial statements and as such, ensuring the financial statements are reliable and of utmost importance. The directors of Sunshine Ltd. are ethically responsible to produce financial statements that comply with Ind AS and are transparent and free from material error. Lenders often attach covenants to the terms of the agreement in order to protect their interests in an entity. They would also be of crucial importance to potential debt and equity investors when assessing the risks and returns from any future investment in the entity.

The proposed action by Sunshine Ltd. appears to be a deliberate attempt to circumvent the terms of the covenants. The legal form would require treatment as a series of short-term leases which would be recorded in the profit or loss, without any right-of-use asset and lease liability being recognized as required by Ind AS 116 'Leases'. This would be a form of 'off-balance sheet finance' and would not report the true assets and obligations of Sunshine Ltd. As a result of this proposed action, the liquidity ratios would be adversely misrepresented. Further, the operating profit margins would also be adversely affected, as the expenses associated with the lease are likely to be higher than the deprecation charge if a leased asset was recognized, hence the proposal may actually be detrimental to the operating profit covenant.

Sunshine Ltd. is aware that the proposed treatment may be contrary to Ind AS. Such manipulation would be a clear breach of the fundamental principles of objectivity and integrity as outlined in the Code of Ethics. It is important for a chartered accountants to

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exercise professional behaviour and due care all the time. The proposals by Sunshine Ltd. are likely to mislead the stakeholders in the entity. This could discredit the profession by creating a lack of confidence within the profession. The directors of Sunshine Ltd. must be reminded of their ethical responsibilities and persuaded that the accounting treatment must fully comply with the Ind AS and principles outlined within the framework should they proceed with the financing agreement.

However, if the CFO fails to comply with his professional duties, he will be subject to professional misconduct under Clause 1 of Part II of Second Schedule of the Chartered Accountants Act, 1949. The Clause 1 states that a member of the Institute, whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or the regulations made there under or any guidelines issued by the Council. As per the Guidelines issued by the Council, a member of the Institute who is an employee shall exercise due diligence and shall not be grossly negligent in the conduct of his duties.

4. Accounting Treatment

As per Ind AS 37 'Provisions, Contingent Liabilities and Contingent Assets', a provision shall be recognised when:

- An entity has a present obligation (legal or constructive) as a result of a past event;
- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and
- A reliable estimate of the amount of the obligation can be made.

Further, the standard states that if a contract becomes onerous, the present obligation under the contract shall be recognised and measured as a provision. A contract is considered onerous when the unavoidable costs of meeting the obligations under the contract exceed the economic benefits expected to be received from it.

In the given case, the construction project undertaken by Zenith Infrastructure Ltd. is expected to incur substantial additional costs, resulting in an expected loss on the contract. Since reliable estimates of the additional costs are available, the contract has effectively become an onerous contract.

Accordingly, the company should recognise a provision for the expected loss in the financial statements in accordance with Ind AS 37.

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Failure to recognise the provision would result in overstatement of profits and understatement of liabilities, thereby leading to a misleading presentation of the financial performance and financial position of the company.

Ethical Issues

The direction given by the Chief Executive Officer to defer recognition of the provision to the next year creates an ethical dilemma for CA. Neha Kapoor.

The management's intention to avoid recognising the provision in order to present stronger financial results for obtaining contracts and maintaining credit ratings raises concerns regarding the fair presentation of financial statements.

Threats to Fundamental Principles

The situation gives rise to the following threats to the fundamental principles of professional ethics:

1. **Intimidation Threat**

   The CEO's indication that the financial statements should portray a strong performance may exert pressure on the finance manager to ignore the correct accounting treatment. This creates an intimidation threat to the principles of integrity and objectivity.

2. **Advocacy Threat**

   The expectation that the financial statements should support negotiations with lenders and potential clients may compel the finance manager to present information that favours management's interests rather than reflecting the true financial position. This results in an advocacy threat.

Professional Competence and Due Care

The fundamental principle of professional competence and due care requires that a Chartered Accountant should prepare financial statements in compliance with applicable accounting standards.

Since the project contract has become onerous, a provision for the expected loss must be recognised in accordance with Ind AS 37. Not recognising such provision would lead to misstatement of financial statements.

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The Institute of Chartered Accountants of India Code of Ethics requires members to maintain integrity, objectivity, and professional competence while performing their duties.

Appropriate Course of Action

CA. Neha Kapoor should:

- Explain to the CEO the requirements of Ind AS 37 and the implications of not recognising the provision.
- Emphasise that non-recognition would result in misleading financial statements and may affect the credibility of the company.
- If the CEO continues to insist on the incorrect treatment, the matter should be escalated to higher levels of governance, such as the Audit Committee or the Board of Directors.

If CA. Neha Kapoor succumbs to the pressure and accepts the incorrect treatment, it would amount to non-compliance with accounting standards and a breach of the principle of professional competence and due care.

In such a situation, she may be held liable for professional misconduct under Clause (1) of Part II of the Second Schedule of the Chartered Accountants Act, 1949, which states that a member shall be deemed to be guilty of professional misconduct if he or she contravenes the provisions of the Act, Regulations, or Guidelines issued by the Council.

Therefore, CA. Neha Kapoor must ensure that the financial statements are prepared in accordance with the applicable accounting standards and ethical principles, even if this requires escalating the matter to the appropriate governance authority.

5. Ethical and accounting implications:

As per Ind AS 7 'Statement of Cash Flows', cash equivalents are short-term, highly liquid instruments readily convertible to cash and subject to insignificant risk of change in value. Loan given to director has no fixed repayment schedule and likelihood of defaulting is not known. Thus, the classification as a 'cash and cash equivalent' is inappropriate. Instead, loan to director should be shown as a financial asset under Ind AS 109 'Financial Instruments'.

Due to the pressure from directors, CA Suraj knowingly disclosed incorrect information to the bank in projected cash flow statement, thereby compromising the fundamental principles of objectivity, integrity and professional competence.

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- By reporting favourable cash flow projections to bank, objectivity is compromised.
- Integrity is also compromised as by not acting in a straightforward and honest manner, incorrect information is knowingly disclosed.
- The principle of competence requires CA Suraj to prepare the cash flow projection to the best of his professional judgment which would not be the case if the cash flow projection showed a more positive position than what is actually anticipated.

By submitting incorrect projected cash flow statement, CA Suraj would be subject to professional misconduct under clause -1 of Part II of Second schedule of the Chartered Accountants Act 1949.

The clause-1 states that a member of the institute whether in practice or not, shall be deemed to be guilty of professional misconduct, if he contravenes any of the provisions of this Act or regulations made thereunder or any guidelines issued by the council.

Guidance to appropriate action

- As a professional, CA Suraj is responsible for presenting the truth and not to indulge in creative accounting owing to force.
- CA Suraj should put the interest of the Company and professional ethics first and must insist that the projected cash flow statement to the bank should be an honest reflection of the company's current financial position. He must prevent deliberate misrepresentation to the said bank.
- CA Suraj should not allow any undue influence and force from the directors to override his professional judgement or integrity.
- By not providing incorrect projected cash flow statement and by adhering to ethical principles, CA Suraj will maintain his professional integrity and contribute to the trust and reliability placed in the work expected from him.
- As per the guidelines issued by the council of the Institute, a member of the institute who is an employee shall exercise due diligence and shall not be grossly negligent in conduct of his duties.

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