Chapter 39 Professional And Ethical Duty of A Chartered Accountant

1. WHAT ARE ETHICS?

- *Merriam-Webster dictionary defines ethic or ethics as moral principles.*
- *It refers to a theory or system of moral values.*
- *Ethics are the principles that guide how we behave and make decisions.*
- *They govern an individual's conduct.*
- *Ethics also deal with distinguishing between what is good and bad.*
- *It involves understanding our moral duties and obligations.*

2. ETHICAL PRINCIPLES IN FINANCIAL REPORTING

- *ICAI's Code of Ethics (2019) is a set of rules for Chartered Accountants.*
- *The Code is based on the International Federation of Accountants (IFAC) Code of Ethics.*
- *It became effective from July 1, 2020.*
- *The Code defines fundamental principles for Chartered Accountants.*
- *These principles guide the behavior and responsibilities of accountants in serving the public interest.*
- *The Code includes a conceptual framework that helps accountants identify and address threats to following the principles.*
- *It provides requirements and application material on various topics to assist accountants in applying the framework.*

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

- *To become a member of the Institute of Chartered Accountants of India (ICAI), a person must qualify as a Chartered Accountant and register with the institute.*
- *Every member is required to follow the professional and other conduct outlined in the Chartered Accountants Act, 1949.*
- *If a member is found to be guilty of any Professional or Other Misconduct, they can face disciplinary action.*
- *This disciplinary action is governed by Section 21 of the Chartered Accountants Act.*

4. WHAT IS PROFESSIONAL OR OTHER MISCONDUCT FOR A CHARTERED

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).

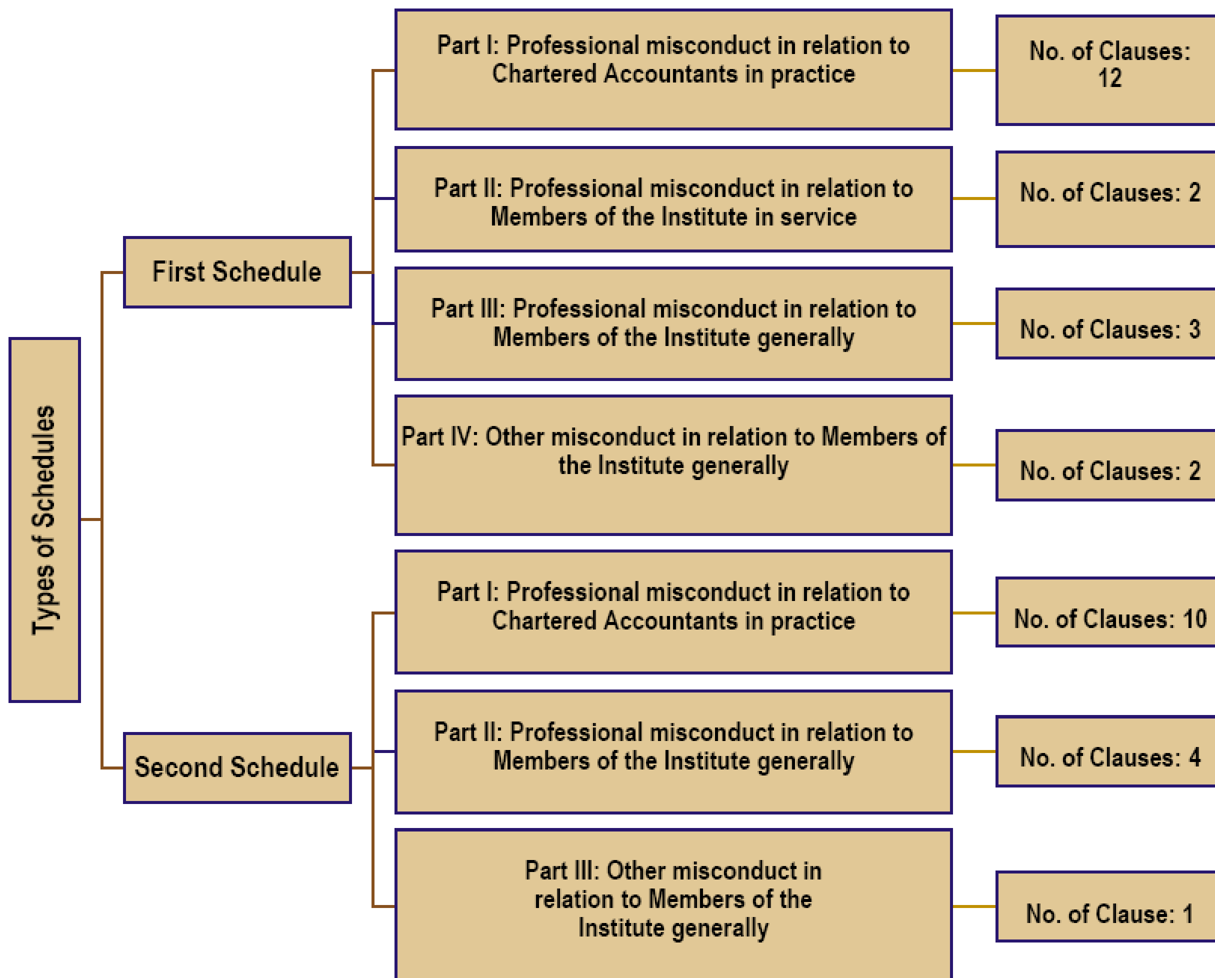
4.1 Professional Misconduct

- *Professional misconduct is defined in Part I, II, and III of the First Schedule, and Part I and II of the Second Schedule.*
- *The Schedules contain provisions for the expected conduct of Chartered Accountants.*
- *Members, whether in practice or in service, must follow the provisions in the relevant parts of the schedules.*
- *If a member is found guilty of any acts or omissions listed in the schedules, it is considered professional misconduct.*

4.1 Other Misconduct

- *Other misconduct is defined in Part IV of the First Schedule and Part III of the Second Schedule.*

- *These provisions give the Council the authority to investigate any misconduct by a member, even if it is not related to their professional work.*
- *It is important for a chartered accountant to maintain high standards of integrity in both professional and personal matters.*
- *Any deviation from these standards, even in non-professional work, can lead to disciplinary action against the member.*



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'.

SECOND SCHEDULE TO THE CHARTERED ACCOUNTANTS ACT, 1949					
➡	***Part I - Professional Misconduct in relation to Chartered Accountants in Practice: (10 clauses)***				
	➡	***CLAUSE 1***	➡	*Discloses Information acquired in the course of his professional engagement to any person other than his client so engaging him without the consent of his client or otherwise than as required by any law for the time being in force.*	
	➡	***CLAUSE 2***	➡	*Certifies or submits in his name or in the name of his firm, a report of an examination of financial statements unless the examination of such statements and the related records has been made by him or by a partner or an employee in his firm or by another chartered accountant in practice.*	
	➡	***CLAUSE 3***	➡	*Permits his name or the name of his firm to be used in connection with an estimate of earnings contingent upon future transactions in manner which may lead to the belief that he vouches for the accuracy of the forecast.*	

	➡	**CLAUSE 4**	➡	*Expresses his opinion on financial statements of any business or enterprise in which he, his firm, or a partner in his firm has a substantial interest.*
	➡	**CLAUSE 5**	➡	*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**	➡	*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**	➡	*Does not exercise due diligence or is grossly negligent in the conduct of his professional duties.*
	➡	**CLAUSE 8**	➡	*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.*
	➡	**CLAUSE 9**	➡	*Fails to invite attention to any material departure from the generally accepted procedure of audit applicable to the circumstances.*
	➡	**CLAUSE 10**	➡	*Fails to keep moneys of his client other than fees or remuneration or money meant to be expended in a separate banking account or to use such moneys for purposes for which they are intended within a reasonable time.*
	PART II - Professional misconduct in relation to members of the Institute generally (4 clauses)			
	➡	CLAUSE 1	➡	*Contravenes any of the provisions of this Act or the regulations made there under or any guidelines issued by the Council*.*
	➡	CLAUSE 2	➡	*Being an employee of any company, firm or person, discloses confidential information acquired in the course of his employment except as and when required by any law for the time being in force or except as permitted by the employer.*
	➡	CLAUSE 3	➡	*Includes in any information, statement, return or form to be submitted to the Institute, Council or any of its Committees, Director (Discipline), Board of Discipline. Disciplinary Committee, Quality Review Board or the Appellate Authority any particulars knowing them to be false.*
	➡	CLAUSE 4	➡	*Defalcates or embezzles money received in his professional capacity.*
	Part III - Other misconduct in relation to members of the Institute generally (1 clause)			
	➡	CLAUSE 1	➡	*A member of the Institute, whether in practice or not, shall be deemed to be guilty of other misconduct, if he is held guilty by any civil or criminal court for an offence which is punishable with imprisonment for a term exceeding six months.*

***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).*

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

1. COMPLYING WITH THE CODE

- *Accountants have a responsibility to act in the public interest.*
- *The Code of Ethics helps them fulfill this responsibility.*
- *Accountants should comply with the Code, but if laws or regulations prevent them from doing so, they should follow the laws and regulations instead.*
- *Professional behavior requires compliance with relevant laws and regulations.*
- *Accountants should be aware of local regulations and follow the stricter 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 -*** *not to compromise professional or business judgments because of bias, conflict of interest or undue influence of others.*

(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 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 comply with relevant laws and regulations and 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.

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.

3. INTEGRITY

- *Chartered Accountants must comply with the principle of integrity, being honest and straightforward in professional and business relationships.*
- *Accountants should not be involved with reports, returns, or other information that they know contains materially false or misleading statements.*
- *They should not provide statements or information negligently.*
- *Accountants should not omit or obscure required information if it would be misleading.*

4. OBJECTIVITY

A Chartered Accountant shall comply with the principle of objectivity, which requires an accountant not to compromise professional or business judgment because of bias, conflict of interest or undue influence of others.

PROBLEM 1 :- (Source : Study Material)

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 f 2 crores.

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 f 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.

SOLUTION : 1

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 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.

5. PROFESSIONAL COMPETENCE AND DUE CARE

- *Professional competence requires accountants to stay updated on technical, professional, and business developments.*
- *Continuing professional development helps accountants maintain their capabilities and perform competently.*
- *Diligence means acting carefully, thoroughly, and promptly in fulfilling assignments.*
- *Accountants should ensure that their team members receive appropriate training and supervision to meet professional competence and due care standards.*

PROBLEM 2 :- (Source : Study Material)

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 : 2

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, 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.

6. CONFIDENTIALITY

- *Accountants must maintain confidentiality, respecting the privacy of information obtained in their professional and employment relationships.*
- *They should be cautious about accidental disclosure, especially to close associates or family members.*
- *Accountants must keep information confidential within their firm or organization.*
- *They should protect the confidentiality of information shared by potential clients or employers.*
- *Accountants should not disclose confidential information without proper authority, unless required by law or professional duty.*
- *They must not use or share confidential information for personal gain or with third parties.*
- *Accountants should ensure their team members and advisors also respect confidentiality.*
- *In providing payroll services, confidentiality is crucial unless required by law or authorized by the client.*
- *Confidentiality allows free information exchange, but disclosure may be necessary in certain situations, like legal requirements or client authorization.*
- *Accountants should continue to maintain confidentiality even after the professional relationship ends.*
- *They should not use or disclose confidential information when changing employment or acquiring new clients.*
- *Accountants have an ethical duty to report fraud or non-compliance that can harm stakeholders.*
- *Professional judgment and legal advice should guide the application of confidentiality.*
- *Prior experience can be used, but confidential information should be protected.*

7. PROFESSIONAL BEHAVIOUR

- *Accountants must promote themselves and their work without bringing the profession into disrepute.*
- *They should conduct their affairs to avoid professional misconduct.*
- *Accountants should be honest and not make exaggerated claims about their services or qualifications.*
- *They should refrain from making disparaging remarks or unsupported comparisons to others.*
- *Accountants should follow the Advertisement Guidelines issued by the Institute's Council.*

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) Exercise professional judgment;

(b) Remain alert for new information and to changes in facts and circumstances; and Use the reasonable and informed third party test.

Exercise of Professional Judgment

- *Professional judgment involves using training, knowledge, and experience to make informed decisions.*
- *Accountants must apply a conceptual framework to determine appropriate actions.*
- *Understanding facts and circumstances is crucial for applying the framework and making decisions.*
- *Accountants need to consider missing information, inconsistencies, and their own expertise.*
- *They should consult others if needed and ensure the information is reasonable.*
- *Accountants should be aware of biases and consider alternative conclusions.*

Reasonable and Informed Third Party

- *Accountants consider the reasonable and informed third party test.*
- *It involves imagining how another party would likely reach the same conclusions.*
- *The test is based on a reasonable and informed perspective, not necessarily from an accountant.*
- *The third party weighs all the relevant facts and circumstances known to the accountant.*
- *They possess the necessary knowledge and experience to impartially evaluate the conclusions.*

PART II : CHARTERED ACCOUNTANTS IN SERVICE

A. CONFLICTS OF INTEREST

- *A Chartered Accountant must avoid conflicts of interest that could compromise their judgment.*
- *Examples of situations that could create conflicts of interest are:*
- *Holding management or governance positions in two organizations and using confidential information from one organization to benefit or harm the other.*
- *Assisting both parties in a partnership dissolution as a professional activity.*
- *Providing financial information for management members pursuing a management buy-out.*
- *Being involved in vendor selection when a family member could financially benefit.*
- *Serving in a governance role for an organization approving investments that would increase the accountant's or a family member's investment portfolio value.*

1. Conflict Identification

- *A Chartered Accountant must make efforts to recognize situations that could lead to conflicts of interest.*
- *Steps to identify conflicts of interest include:*
- *Understanding the nature of interests and relationships between involved parties.*
- *Evaluating the activity and its impact on relevant parties.*

2. Threats Created by Conflict of Interest

- *When there is a strong connection between a professional activity and conflicting interests, the threat level is higher and not considered acceptable.*
- *Withdrawing from the decision-making process regarding the conflicting matter is an example of an action that can eliminate threats caused by conflicts of interest.*
- *Safeguards can be implemented to address conflicts of interest, such as:*
- *Restructuring or separating specific responsibilities and duties.*
- *Seeking appropriate oversight, such as supervision from an executive or non-executive director.*

3. Disclosure and Consent

It is generally necessary to:

- *Disclose the conflict of interest and how threats were addressed to the relevant parties.*
- *Obtain consent from the parties involved when safeguards are applied.*
- *Seek guidance from the employing organization, Institute, legal counsel, or other accountants.*
- *Maintain confidentiality when sharing information and seeking guidance.*

PROBLEM 3 :- (Source : Study Material)

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 3 :

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.*

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 n(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.

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.*

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

While preparing or presenting information the Chartered Accountant shall:

- *Exercise discretion in professional judgments without intending to mislead or influence outcomes inappropriately.*
- *Examples of misuse of discretion include manipulating estimates, selecting accounting policies, timing transactions, structuring transactions, and selecting disclosures to misrepresent information.*
- *Consider the purpose, context, and audience when exercising professional judgment.*
- *In pro forma reports, budgets, or forecasts, include relevant estimates, approximations, and assumptions for informed decision-making.*

2. Relying on the Work of Others

- *When a Chartered Accountant plans to rely on the work of others, they must exercise professional judgment to decide the appropriate steps to fulfill their responsibilities.*
- *Factors to consider for determining reasonable reliance include the reputation, expertise, and resources of the other individual or organization.*
- *Consider whether the other individual is subject to relevant professional and ethics standards.*
- *Prior association with or consulting others can provide information about the reliability of the other individual or organization.*

3. Addressing Information that Is or Might be Misleading

- *When a Chartered Accountant encounters misleading information, they should take appropriate action.*
- *Actions include discussing concerns with superiors or management and requesting corrective measures.*
- *Consultation with the organization's policies and procedures is recommended.*
- *If the organization fails to address the issue, the accountant can seek guidance from the Institute, auditors, and legal counsel.*
- *Determine if there are requirements to report the issue to third parties or regulatory authorities.*
- *If all options are exhausted and the information remains misleading, the accountant should disassociate themselves from it.*
- *Resignation from the organization may be necessary in such cases.*

PROBLEM 4 :- (Source : Study Material)

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 : 4

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' 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 must not mislead their employing organization about their expertise or experience.*
- *Lack of time, incomplete information, insufficient experience, or inadequate resources can create a self-interest threat to professional competence and due care.*
- *Safeguards to address this threat include seeking assistance or training from knowledgeable individuals and ensuring sufficient time for the duties.*

➡ *If the threat cannot be resolved, the accountant should consider declining the duties and communicate the reasons.*

PROBLEM 5 :- (Source : Study Material)

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 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 : 5

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. 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 must not manipulate or misuse confidential information for personal or financial gain.*
- *Financial interests of the accountant or their immediate/close family members can create threats to compliance with the fundamental principles.*
- *Examples of self-interest threats include:*
  - *Manipulating price-sensitive information for personal financial gain.*
  - *Having financial interests in the employing organization affected by the accountant's decisions.*
  - *Being eligible for profit-related bonuses influenced by the accountant's decisions.*
  - *Holding deferred bonus share rights or options affected by the accountant's decisions.*
  - *Participating in compensation arrangements incentivizing specific performance targets.*
- *These circumstances compromise objectivity and integrity.*
- *Safeguards should be implemented to address these threats and prevent conflicts of interest.*
- *Adhering to ethical guidelines and seeking guidance is important when conflicts of interest arise.*

PROBLEM 6 :- (Source : Study Material)

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 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 : 6

*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 **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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PROBLEM 7 :- (Source : Study Material)

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 < f 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 f 2 crores.

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 f 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.

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 : 7

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

Required:

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.

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

- *Inducements are used to influence someone's behavior, but not necessarily with improper intent.*
- *They can range from small acts of hospitality to actions that lead to non-compliance with laws.*
- *Examples of inducements include gifts, hospitality, entertainment, political or charitable donations, appeals to friendship and loyalty, employment or commercial opportunities, and preferential treatment.*
- *Inducements can come in various forms and can be used to gain favor or special treatment.*
- *Chartered Accountants must be cautious when faced with inducements to ensure they maintain their integrity and comply with ethical standards.*

1. Immediate or Close Family Members

- *Chartered Accountants must be alert to threats arising from inducements offered by or to their immediate or close family members in relation to their professional relationships.*
- *If an accountant suspects that an inducement is intended to improperly influence their behavior or that of a counterparty, they should advise their family member against offering or accepting the inducement.*
- *The nature and closeness of relationships between the accountant, family member, and counterparty play a role in determining whether there is an intent to improperly influence behavior.*
- *For example, if a counterparty offers a job to the accountant's spouse outside the normal hiring process during contract negotiations, it may raise suspicions of improper intent.*
- *Accountants must uphold ethical standards, avoid conflicts of interest, and act with integrity in such situations.*

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

- *Chartered Accountants may encounter non-compliance or suspected non-compliance in their work.*
- *They should assess the implications and determine how to respond to non-compliance with laws and regulations.*
- *The accountant's objectives are to act with integrity, alert management or governance bodies, and take further action in the public interest.*
- *Non-compliance involves actions contrary to laws or regulations by the employing organization, governance bodies, management, or individuals under their direction.*

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.*
- *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 Senior Chartered Accountants in Service

- *Senior Chartered Accountants are directors, officers, or senior employees with significant influence over the organization's resources.*
- *They have a higher expectation to take appropriate action in the public interest when addressing non-compliance or suspected non-compliance.*
- *This expectation is due to their roles, positions, and influence within the organization.*

1. Addressing the Matter

- *A senior Chartered Accountant who identifies or suspects non-compliance should discuss the matter with their immediate superior or higher authority.*
- *They should ensure the matter is communicated to those in charge of governance.*
- *Compliance with laws and regulations regarding reporting non-compliance should be followed.*
- *Steps should be taken to rectify and mitigate the consequences of non-compliance.*
- *Efforts should be made to prevent future non-compliance and deter its occurrence.*
- *Consideration should be given to disclosing the matter to the external auditor, if required for their audit duties or legal obligations.*

2. Determining Whether Further Action Is Needed

- *The senior Chartered Accountant will evaluate the response of their superiors and those in charge of governance.*
- *Loss of confidence in superiors and those in charge of governance may occur if the accountant suspects their involvement in non-compliance or if they fail to report the matter to the appropriate authority within a reasonable time.*
- *Additional actions that the senior Chartered Accountant can take include informing the parent company's management if the organization is part of a group, reporting the matter to an appropriate authority as required by law, or resigning from the employing organization.*
- *Resignation should not be the sole action taken, but there may be limitations on other available actions, making resignation the only option in some cases.*

3. Seeking Advice

As assessment of the matter might involve complex analysis and judgments, the senior Chartered Accountant 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.*

4. Determining Whether to Disclose the Matter to an Appropriate Authority

- *Disclosure to an appropriate authority is prohibited if it contradicts the law or regulations.*
- *The purpose of making a disclosure is to enable an appropriate authority to investigate the matter.*
- *Disclosing the matter allows action to be taken in the public interest.*

5. Responsibilities of Chartered Accountants Other than Senior Chartered Accountants

- *When a Chartered Accountant becomes aware of non-compliance or suspected non-compliance, they should seek to understand the nature and circumstances of the matter.*
- *If the accountant identifies or suspects non-compliance, they should inform their immediate superior for appropriate action.*

- *If the immediate superior is involved, the accountant should inform the next higher level of authority within the organization.*
- *In exceptional cases, the accountant may decide to disclose the matter to an appropriate authority.*
- *When making a disclosure, the accountant should act in good faith and be cautious in their statements.*

PROBLEM 8 :- (Source : Study Material)

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 ƒ 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 : 8

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 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 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 must not succumb to pressure that would lead to violating the fundamental principles or pressure others to do so.*
- *Pressure from various sources, both internal and external, can pose threats to compliance with the fundamental principles.*
- *Examples of pressure include conflicts of interest, where a family member bids for a contract with the accountant's organization.*
- *The accountant should discuss and consult with others while maintaining confidentiality to assess the level of the threat.*
- *Discussions may involve addressing the pressure directly with the person exerting it or informing a superior if they are not involved.*
- *Escalating the matter within the organization, disclosing it according to policies, and seeking consultation from colleagues, associations, or legal counsel are potential steps.*
- *Restructuring responsibilities or segregating duties can help eliminate threats caused by pressure.*

PROBLEM 9 :- (Source : Study Material)

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.

SOLUTION : 9

(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 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 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.

TEST YOUR KNOWLEDGE

PROBLEM 10 :- (Source : Study Material)

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.

Required:

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.

SOLUTION : 10

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 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, 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 manging 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 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.*