Companies (Auditor's Report) Order, 2003

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The Central Government, in exercise of the powers conferred, under sub-section (4A) of section 227 of the Companies Act, 1956, has issued Companies (Auditor's Report) Order, 2003. This was further amended by the Companies (Auditor's Report) (Amendment) Order, 2004, issued by the Ministry of Company Affairs recently.

The matters to be included in the auditor's report are specified in paragraph 4 of the Order and it requires the auditor to make a statement on all the matters contained therein.

Matters to be included in the Auditor's report

(i) (a) Whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets.

(b) Whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;

(c) If a substantial part of fixed assets have been disposed off during the year, whether it has affected the going concern;

✍ Companies are not required to confirm the validity of going concern assumption in their financial statements.

✍ If in the well considered opinion of the auditor the question of resolving the going concern would arise, the auditor should comply with the requirement of Auditing and Assurance Standard (AAS) 16, "Going Concern".

(ii) (a) Whether physical verification of inventory has been conducted at reasonable intervals by the management;

(b) Are the procedures of physical verification of inventory followed by the management reasonable and adequate in relation to the size of the company and the nature of business? If not, the inadequacies in such procedure should be reported;

(c) Whether the company is maintaining proper records of inventory and whether any material discrepancies were noticed on physical verification and if so, whether the same has been properly dealt with in the books of account;

✍ The term "inventory" is not defined in the Order. In this regard a reference can be made to Para 4 of Accounting Stamdard-2 on inventories.

(iii) (a) Has the company either granted or taken any loans, secured or unsecured to/from companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and amount involved in the transactions.

The auditor is required to disclose the requisite information **irrespective of the period to which such loan relates.**

(b) Whether the rate of interest and other terms and conditions of loans given or taken by the company, secured/or unsecured, are prima-facie prejudicial to the interest of the company;

(c) Whether payment of the principal amount and interest on loans taken by the company are **also** regular;

✍ An appropriate interpretation of clause(c) would be that the auditor is also required to comment on the regularity of the receipt of principal amount and interest on loan "given" by the company.

(d) if overdue amount is more than rupees one lakh, whether reasonable steps have been taken by the company for recovery/payment of the principal and interest;

(iv) Is there an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets, for the sale of goods and for the **sale of services?**

✍ Obtaining an understanding of internal control systems is a normal audit procedure; **the duty of the auditor to examine internal control with regard to other areas is not in any way diminished.**

Whether there is a continuing failure to correct major weaknesses in internal control;

✍ In cases where the weakness has been corrected by the date of auditor's report, the auditor should state fact that although at the balance sheet date, there was a continuing failure to correct a major weakness on the date of the financial statements, the weakness has been corrected by the date the auditor issued the report."

(v) (a) Whether transactions that need to be entered into a register in pursuance of section 301 of the Act have been so entered;

(b) Whether each of **these transactions** have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time;

(This information is required only in case of transactions exceeding the value of **five lakh rupees** in respect of any party and in any one financial year).

✍ To illustrate, in a purchase transaction, when the rates paid are higher than the prevailing market prices, the auditor has to use his **professional judgement** to determine whether the difference in rates is reasonable having regard to the other factors such as the previous record of the supplier/buyer/client, the credit terms, etc.

(vi) In case the company has accepted deposits from the public, whether the directives issued by the Reserve Bank of India and the provisions of sections 58A and 58AA of the Act and the rules framed there under, where applicable, have been complied with. If not, the nature of contraventions should be stated;

If an order has been passed by Company Law Board, **NCLT, RBI, Court, or other Tribunal** whether the same has been complied with or not? [Added]

✍ In the event of default, these independent bodies may direct the company to make repayment of deposit. In an era of vanishing companies that leave their shell deceiving the innocent public of their money, the stakeholders should know the true financial status through this annual reporting by the auditor.

(vii) In the case of listed companies **and/or** other companies having a paid-up capital and reserves exceeding Rs.50 lakhs as at the commencement of the financial year concerned or having an average annual turnover exceeding Rs.5 Crore for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business;

✍ For listed companies irrespective of its capital or turnover, the auditor will have to report on the adequacy and effectiveness of internal audit system.

- ✍ The Act **does not** require a company to necessarily have an internal audit system. However, where such a system does not exist, the Order requires the auditor to mention the fact in his report.

(viii) Where one or more clauses of the Order are not applicable, it would be appropriate for the auditor to make a suitable comment in his report bringing out the fact of non-applicability of a particular clause. To illustrate, the auditor may state:

"The Central Government has not prescribed maintenance of cost records under section 209(1) (d) of the Act for any of the product of the company as mentioned in clause 8 of the Order."

(ix) (a) Is the company **regular** in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Employees' State Insurance, Income Tax, Sales Tax, Wealth tax, Custom Duty, Excise duty cess, **service tax** and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.

In cases where there are no arrears on the balance sheet day but the company has been irregular during the year in depositing the statutory dues, the auditor should state this fact in his audit report.

(b) In case dues of sales tax/income tax/ custom tax/wealth tax/excise duty/cess/ **service tax** have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending may please be mentioned.

(A mere representation to the Department shall not constitute the dispute)

CARO calls for reporting on both undisputed and disputed dues unlike MAOCARO, which called for reporting on undisputed dues only.

(x) Whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than fifty percent of its net worth and whether it has incurred cash losses in such financial year and in the financial year immediately preceding such financial year also;

- ✍ The Companies (Auditor's Report) (Amendment) Order, 2004, issued by the Ministry of Company Affairs recently, alters this clause such that an auditor will have to report upon this clause, even when such a company has not incurred cash losses in the immediately preceding financial year.

- ✍ The figures of net worth and cash loss computed for the financial year should also be adjusted for the effects of qualifications in the audit report to the extent the qualifications are quantified.

- ✍ It appears that cash losses have to be reported starting from the year in which the net worth is eroded by 50%. This may not give an early warning signal to share holders on potential sickness. It is preferable if auditors are required to report on cash loss incurred in any financial year.

(xi) Whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount default to be reported;

- ✍ In case of dispute between the company and the lender, the auditor should give a disclaimer stating that he is unable to determine whether there is a default in repayment of dues to the lender concerned.

(xii) Whether adequate documents and records are maintained in cases where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities; If not, the deficiencies to be pointed out.

- ✍ The term 'other securities' is used along with shares and debentures and, therefore, for the purpose of this clause, consideration will have to be confined to securities which are similar to shares or debentures.

(xiii) Under clause 13, the auditor has to satisfy himself and report that, whether a Chit Fund company has complied with all the provisions of the special statutes **in so far as they are applicable to the accounts** of the chit fund company.

In respect of nidhi/ mutual benefit fund/ societies, the auditor has to report;

(a) Whether the net-owned funds to deposit liability ratio is more than 1:20 as on the date of balance sheet;

(b) Whether the company has complied with the prudential norms on income recognition and provisioning against sub-standard/ default/loss assets;

(c) Whether the company has adequate procedures for appraisal of credit proposals/ requests, assessment of credit needs and repayment capacity of the borrowers;

(d) Whether the repayment scheduled of various loans granted by the nidhi is based on the repayment capacity of the borrower and would be conducive to recovery of the loan amount;

- ✍ In case a nidhi or mutual benefit society has not complied with the prudential norms for revenue recognition and classification of assets, the auditor apart from giving an appropriate comment under the Order, should also make a suitable **qualification in the audit report on the financial statements.**

(xiv) If the company is dealing or trading in shares, securities, debentures **and** other investments, whether proper records have been maintained of the transactions and contracts and whether timely entries have been made therein; also whether the shares, securities, debentures and other securities have been held by the company, in its own name.

- ✍ However, section 49(4) specifically exempts companies whose principal business is the buying and selling of shares or securities from this requirement of holding investments in its own name. It seems, therefore, that the requirements to report will arise when the buying and selling of shares or securities is not the principal business of the company but it does some business along with some other business.

(xv) Whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and conditions whereof are prejudicial to the interest of the company;

(xvi) Whether term loans were applied for the purpose for which the loans were obtained;

- ✍ Term loans are generally provided by banks and financial institutions for acquisition of capital assets which then become the security for the loan, i.e., end use of funds is normally fixed.
- ✍ In case of term loans from banks, raised against title deeds, long term FDRs, NSCs etc., where the bank is not concerned with the purpose for which it is being obtained, the auditor should clearly mention the fact that in the absence of any stipulation regarding the utilization of loans from the lender, he is unable to comment as to whether the term loans have been applied for the purpose for which they were obtained.

(xvii) Whether the funds raised on short term basis have been used for long term investment; If yes, the nature and amount is to be indicated;

- ✍ **All funds** raised by a company are reportable under this clause.
- ✍ Paragraph 70 (b) of the Statement on CARO, 2003 issued by the Institute of Chartered Accountants of India states that the auditor while commenting on this clause **should restrict** his examination and

comments to the figures and **data given in the financial statements of the company.**

(xviii) Whether the company has made any preferential allotment of shares to parties and companies covered in the Register maintained under section 301 of the Act and if so whether the price at which shares have been issued is prejudicial to the interest of the company;

- The term "shares" includes equity as well as preference shares.
- The clause requires the auditor to report on the preferential allotment **only in case of shares issued** by the company and not on preferential allotment of other securities issued by the company.
- **The preference can be with regard to the price or other terms and conditions associated with the allotment.**

(xix) Whether security or charge has been created in respect of debentures issued?

(xx) Whether the management has disclosed the end use of money raised by public issues and the same has been verified;

- In the absence of any legal requirement to disclose the end use of money raised by public issues in **the financial statements** and the Order mandating the auditor to verify the disclosure of end-use of the monies raised through public issues, it is interpreted that the Order, apart from requiring the auditors to comment on the disclosures, **also requires the companies to disclose the requisite information.**

(xxi) Whether any fraud on or by the company has been noticed or reported during the year, if yes, the nature and the amount involved is to be indicated.

- The auditor being **an unbiased and independent agency** is placed under an obligation to report to the stakeholders on any fraud noticed by statutory authorities or by him or reported to statutory authorities or brought to his notice during the year.
- While reporting on matters specified in the Order, the auditor should consider **the materiality** of the item involved.
- However, if a fraud has been committed by of senior members of the management or by those charged with the governance of the entity, this may be indicative of larger problems. Here materiality of the amount involved in the fraud is irrelevant and the auditor would do well in bringing it in his report.

<u>Reasons to be stated …</u>

Where, in the auditor's report, the answer to any of the questions referred to in paragraph 4 is unfavourable or qualified answer or he is unable to express any opinion, **the auditor's report shall also state the reasons for such an answer.**

<u>Form of Report</u>

- In the case of companies which have been exempted from the applicability of the Order unconditionally i.e. banking companies, insurance companies and section 25 companies, the auditor need not mention anything about the exemption from applicability of the Order in his report. However, in the case of a private limited company it would be appropriate for the auditor to mention in his report that the company is exempted from the applicability of the Order.
- The branch auditor has the same reporting responsibilities in respect of the branch as those of the auditor appointed under section 224 of the Act as in respect of the company. The comments of the branch auditor in respect of the branch are dealt with by the auditor of the company appointed under section 224 of the Act while finalizing his report under the Order.
- The manner of reporting, in the case of liaison offices, project offices and branch offices of foreign companies would be similar to that what is adopted in the case of a branch office of an Indian company.

<u>Conclusion</u>

- I am thankful to the Institute of Chartered

Accountants of India for promptly bringing out Statements on CARO, 2003 & Issues on CARO, 2003, which contained extensive guidance on all the clauses and several such issues arising out of CARO, 2003.

- It can be seen that **the amended CARO is even more stringent.** The provisions of revised CARO are sweeping covering **the length and breadth of the organization.** To succeed in this new mission, there are three pre-requisites: First, the auditor has to keep his sixth sense always on the alert. Second he would need the close cooperation of the management and last but not the least he would need qualified assistants who can make their contribution.

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