

Draft

**Statement on Companies
(Auditor's Report) Order, 2003**

[Issued under Section 227 (4A) of the Companies Act, 1956]



Auditing and Assurance Standards Board

**The Institute of Chartered Accountants of India
New Delhi**

STATEMENT ON THE COMPANIES
(AUDITOR'S REPORT) ORDER, 2003
[Issued under Section 227(4A) of the Companies Act, 1956]

Introduction

1. The Central Government, in exercise of the powers conferred, under sub-section (4A) of section 227 of the Companies Act, 1956 (hereinafter referred to as "the Act"), has issued the Companies (Auditor's Report) Order, 2003 (hereinafter referred to as "the Order"), *vide* Notification No. G.S.R. 480(E) dated June 12, 2003. The Order contains certain reporting requirements for the auditors of the classes of companies specified in the Order. The text of the Order is given in Appendix I to the Statement.

2. The Order supersedes the earlier Order issued in 1988, viz., the Manufacturing and Other Companies (Auditor's Report) Order, 1988. (MAOCARO, 1988). Appendix II to this Statement contains a clause-by-clause comparison of the reporting requirements of the Order and MAOCARO, 1988. It would be clear from the comparison that the Order seeks to rationalize the requirements of the earlier Order in a number of ways, besides adding certain new clauses. Some of the clauses of erstwhile MAOCARO, 1988 have not found place in the Order.

3. The purpose of this Statement¹ is to enable the members to comply with the reporting requirements of the Order. It should, however, be noted that the clarifications and guidelines contained in this Statement are not intended to be exhaustive and the auditors should exercise their professional judgment and experience on various matters on which they are required to report under the Order.

¹ The 'Statements' are issued with a view to securing compliance by members on matters which in the opinion of the Council are critical for the proper discharge of their functions.' Statements' therefore are mandatory. Accordingly, while discharging their attest function, it will be duty of the members of the Institute to ensure that the 'Statements' relating to auditing matters are followed in the audit of financial information covered by their audit reports. If for any reason a member has not been able to perform an audit in accordance with such 'Statements', his report should draw attention to the material departures there from. Attention is invited in this regard to the "Clarification regarding Authority Attached to the Documents Issued by the Institute" published in the December, 1985 issue of the Institute's Journal "The Chartered Accountant".

General Provisions Regarding Auditor's Report

4. The requirements of the Order are supplemental to the existing provisions of section 227 of the Act regarding the auditor's report. However, there are certain points of distinction between the Order and the requirements of section 227, which are as follows:

- (i) the provisions of sub-sections (1A), (2), (3) and (4) of section 227 are applicable to all companies while the Order exempts certain classes of companies from its application.
- (ii) the provisions of sub-section (1A) require the auditor to make certain specific enquiries during the course of his audit. The auditor is, however, not required to report on any of the matters specified in the sub-section unless he has any special comments to make on the said matters. If he is satisfied with the results of his enquiries, he has no further duty to report that he is so satisfied. The Order, on the other hand, requires a statement on each of the matters specified therein even if he has no comments to make on any of the matter(s) contained in the Order. In that respect, the provisions of the Order are similar to the provisions of sub-sections (2), (3) and (4) of section 227.

5. Another question that arises is about the status of the Order *vis a vis* the directions given by the Comptroller and Auditor General of India under section 619 of the Act. In this regard, it may be noted that the Order is supplemental to the directions given by the Comptroller and Auditor General of India under section 619 of the Act in respect of government companies. These directions continue to be in force. Therefore, in respect of government companies, the matters specified in the Order will form part of the auditor's report submitted to the members and the replies to the questionnaire issued by the Comptroller and Auditor General of India under section 619 will continue to be submitted as hitherto.

Applicability of the Order

6. The Order applies to all companies except certain classes of companies specifically exempted from the application of the order. The Order, therefore, is also applicable to foreign companies as defined in section 591 of the Act as well as the government companies, but does not apply to bodies corporate that are not companies. Banking companies, insurance companies, companies

licensed to operate under section 25 of the Act, and certain category of private limited companies, as specified in the Order have been exempted from the applicability of the Order.

7. The Order is also applicable to the audits of branches since sub-section 3(a) of section 228 of the Act, clearly specifies that the branch auditor has the same duties in respect of audit as the company's auditor. It is, therefore, necessary that the report submitted by the branch auditor contain a statement on all the matters specified in the Order to enable the company's auditor to consider the same while complying with the provisions of the Order.

8. The Order applies to foreign companies also, as defined in Section 591 of the Companies Act, 1956. According to sub-section (1) of the aforesaid section, companies falling under the following two classes are to be construed as foreign companies:

- (a) companies incorporated outside India which, after the commencement of the Act, establish a place of business within India; and
- (b) companies incorporated outside India which have, before the commencement of the Act, established a place of business within India and continue to have an established place of business within India at the commencement of the Act.

9. It needs to be remembered that the Order is not intended to limit the duties and responsibilities of auditors but only requires a statement to be included in the audit report in respect of the matters specified therein. For example, examination of the system of internal control is one of the basic audit procedures employed by the auditor. The fact that the Order requires a statement regarding the internal control applicable only to purchases of inventories and fixed assets and sale of goods is no justification for the auditor to conclude that an examination of internal control regarding the other areas of a company's business is not important or not required.

Classes of Companies Covered by the Order

10. It should be noted that unlike MAOCARO, 1988, the Companies (Auditor's Report) Order, 2003 has done away with the concept of "engages or proposes to engage". The Order, therefore, does not require that the

companies covered by it should be engaged or propose to engage in one or more of the following activities, namely:

- (a) manufacturing, mining or processing;
- (b) supplying and rendering services;
- (c) trading; and
- (d) the business of financing, investment, chit fund, *nidhi* or mutual benefit societies.

11. The Order is applicable to all companies except those as mentioned in paragraph 13 of the Statement. The Order, unlike MAOCARO, 1988, has not been divided into sections containing additional reporting requirements in case of a service company, a trading company or a chit fund, investment, *nidhi* or a mutual benefit company. However, it may be noted that paragraph 2 of the Order, containing the definitions of certain terms used in the Order, still contains definitions of the terms like investment company, service company, manufacturing company, etc.

Companies not Covered by the Order

12. The Order specifically provides that it shall not apply to:

- (i) a banking company as defined in clause (c) of Section 5 of the Banking Regulation Act, 1949 (10 of 1949);
- (ii) an insurance company as defined in clause 21 of section 2 of the Companies Act, 1956 (1 of 1956); and
- (iii) a company licensed to operate under Section 25 of the Companies Act, 1956 (1 of 1956).
- (iv) a private limited company with a paid-up capital and reserves not more than rupees fifty lakhs, which has not accepted any public deposit and does not have outstanding loan exceeding rupees ten lakhs or more from any bank or financial institution and does not have a turnover exceeding rupees five crores.²

²This exemption was not there in the Manufacturing and Other Companies (Auditor's Report) Order, 1988.

13. The Order specifically exempts banking companies and insurance companies from its application.

14. The Order specifically exempts companies which have been licensed to operate under Section 25 of the Companies Act, 1956. The said section applies to companies which have been formed or are about to be formed as limited companies for promoting commerce, art, science, religion, charity or any other useful object and which apply and intend to apply their profits, if any, or other income in promoting their objects and prohibit the payment of any dividend to their members. Such companies are usually in the form of clubs, chambers of commerce, etc.

15. It may be noted that the specific exemption under the Order is given to companies licensed under section 25 of the Companies Act, 1956. However, it would appear that in view of the provisions of section 656 of the Act, the exemption would also extend to similar companies registered under any earlier Companies Act.

16. The Order also specifically exempts from its application a private limited company which fulfils all the following conditions:

- (i) its paid-up capital and reserves are rupees fifty lakhs or less;
- (ii) it has not accepted any public deposit;
- (iii) it has no outstanding loan in excess of rupees ten lakhs from any bank or financial institution; and
- (iv) its turnover does not exceed rupees five crores.

17. A private limited company, in order to be exempt from the applicability of the Order, must satisfy all the conditions mentioned above simultaneously. In other words, if even one of the conditions is not satisfied, a private limited company's auditor has to report on the matters specified in the Order. The nature of conditions indicates that the Order seeks to exempt from the application of the Order, private companies which do not involve public interest because of their size and resource utilisation.

18. There are certain issues which arise out of the above conditions laid down by the Order. The subsequent paragraphs of this section would deal with these issues separately.

(i) Private Limited Company

19. The term “private limited company”, as used in the Order, should be construed to have the same meaning as assigned to the term, “private company” by clause (iii) of sub-section 1 of section 3 of the Companies Act, 1956. According to the said clause, a company should meet the following criteria to qualify as a private company:

- (i) its paid-up capital should be at least rupees one lakh (or such other amount as might be prescribed);
- (ii) its articles of association should contain the following restrictions:
 - (a) a restriction on the right to transfer the shares of the company;
 - (b) a restriction that the maximum number of members of the company would not exceed fifty (excluding certain categories of persons);
 - (c) a restriction prohibiting the company to invite public to subscribe to any of its shares or debentures; and
 - (d) a restriction prohibiting the company to invite or accept any deposits from persons other than its members, directors or their relatives.

20. One of the conditions imposed by the Order for exempting a private limited company is that it should not have accepted any public deposits. It may be noted that by virtue of the provisions of sub-section (iii) of section 3 of the Act, any company which invites/accepts any public deposit would not be covered by the definition of a “private company”. Thus, there seems to be some anomaly in the said requirement of the Order and the provisions of the Act. However, if a private company accepts deposits, apart from other consequences under the Act, the Order would become applicable to such a company.

(ii) Paid-up Capital and Reserves

21. Sub-section (32) of section 2 of the Act defines the term “paid-up capital” as capital credited as paid-up. The Guidance Note on Terms used in Financial Statements, issued by the Institute of Chartered Accountants of India, defines the term “paid-up share capital” as, “that part of the subscribed share capital for which consideration in cash or otherwise has been received. This includes bonus shares allotted by the corporate enterprise”. While calculating the paid-

up capital, amount of calls unpaid should be deducted from and the amount originally paid-up on forfeited shares should be added to the figure of subscribed capital. Paid-up share capital would include both equity share capital as well as the preference share capital.

22. So far as “reserves” are concerned, clause 7(1)(b) of Part III of Schedule VI to the Act, clarifies that the term “reserve” does not include any amount written off by way of providing for depreciation, renewals or diminution in the value of assets or retained by way of providing for any known liability. The Guidance Note on Terms Used in Financial Statements defines the term “reserve” as “The portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by management for a general or specific purpose other than provision for depreciation or diminution in the value of assets or for a known liability.”

23. Reserves can be categorised into two—capital and revenue. For the purpose of determining whether the reserves of the company, together with the paid-up capital, are less than the prescribed limit of rupees fifty lakhs, both capital as well as revenue reserves should be taken into consideration. However, revaluation reserve, if any, should not be taken into consideration. Further, it may be noted that the debit balance of the profit and loss account, if any, should be reduced from the amount of paid-up capital and reserves. Share application money received should not be considered for determination of the limit of paid-up capital and reserves provided it is not pending allotment for a substantial period.

(iii) Turnover

24. The term, “turnover”, has not been defined either by the Order or the Act. However, for the purpose of this clause, the term “turnover” may be interpreted to mean the aggregate amount for which sales are effected or services rendered by an enterprise. If sales tax and excise duty are included in the sales price, no adjustment in respect thereof should be made for considering the quantum of turnover. Trade discounts can be deducted from sales but not the commission allowed to third parties. If, however, the excise duty and/or sales tax recovered are credited separately to Excise Duty or Sales Tax Account being separate accounts and payments to the authority are debited in the same account, they would not be included in the turnover. However, sales of scrap shown separately under the heading “miscellaneous income” will have to be included in turnover. For this purpose turnover would

also include other income like interest, dividends, but not gains on sales of assets etc., as they are not sold in the normal course of business.

(iv) Date of Determination of Limits

25. The Order does not clarify whether the limits relating to paid-up capital and reserves should be tested at the beginning of the year or at the end of the year. Similarly, the date of determination of the turnover for limit specified is also not provided in the Order. It is suggested that for the proper implementation of the Order, the limit of rupees fifty lakhs in respect of paid-up capital and reserves should be determined at the beginning of the accounting period.

26. Further, the Order is silent about the time at which the borrowings of a private limited company are to be determined. In this regard, it is further clarified that if any point of time during the accounting period under audit, a private company's loans outstanding exceed the limit specified in the Order, the Order shall become applicable to the company. It is also not clear whether the amount of 'ten lakhs' is the aggregate of the loans outstanding from banks or financial institutions. Since the words used by the Order are 'any bank or financial institution' it is clarified that the limit of ten lakhs rupees applies in aggregate to all loans and not with reference to each bank or financial institution. For example, if a private limited company has three loans of rupee four lakhs each outstanding from three banks, the company would not be exempt from the applicability of the Order.

(v) Public Deposits

27. The term "deposits" has not been defined in the Companies Act, 1956. However, the Guidance Note on Terms used in Financial Statements, issued by the Institute defines "public deposits" as, "Fixed deposits accepted by an enterprise from the public in accordance with the prevailing rules made in this behalf". Paragraph 2.5 of the Statement on Qualifications in the Auditor's Report", defines "deposits" as "the placing of money or money's worth with a third party, either for safe keeping, or by way of security for performance of the depositor's obligations, or for the purpose of earning interest; in the latter case deposit being with a party who customarily accepts deposits." However, though, normally, a reference to "a party who customarily accepts deposits", would be construed as that to a bank or non-banking financial institution, companies other than non-banking financial companies may also invite and

accept deposits from public in accordance with the provisions of section 58 and 58AA of the Companies Act, 1956 and might not, as such be customarily accepting the public deposits. Section 45I of the Reserve Bank of India contains a definition of the term, “deposit”. Though the definition is in the context of banks etc., the following salient features of a deposit emerge from that definition:

- (i) a deposit does not include amount raised by way of capital;
- (ii) amounts received in the ordinary course of business, by way of security deposit, dealership deposit, earnest money, advance against order for goods, properties, services etc.

(vi) Financial Institution

28. Section 45I (c) of the Reserve Bank of India Act, 1934 defines the term “financial institution” as “any non-banking institution which carries on as its business or part of its business any of the following activities, namely:

- (i) the financing, whether by way of making loans or advances or otherwise, of any activity other than its own;
- (ii) the acquisition of shares, stock, bonds, debentures or securities issued by a Government or local authority or other marketable securities of a like nature;
- (iii) letting or delivering of any goods to a hirer under a hire-purchase agreement as defined in clause (c) of Section 2 of the Hire Purchase Act, 1973 (26 of 1972);
- (iv) the carrying on any class of insurance business;
- (v) managing, conducting or supervising, as foreman, agent or in any other capacity, or chits or *kuries* as defined in any law which is for the time being in force in any State, or any business, which is similar thereto; and
- (vi) collecting, for any purpose or under any scheme or arrangement by whatever name called, monies in lump sum or otherwise, by way of subscriptions or by sale of units, or other instruments or in any other manner or awarding prizes or gifts, whether in cash or kind, or disbursing monies in any other way, to persons from whom monies are collected or to any other persons.”

29. The Reserve Bank of India Act, 1934 excludes from the definition of a financial institution, any institution carrying on any of the following activities as its principal business:

- (i) agricultural operations; or
- (ii) industrial activity, as defined in section 2(c) of the Industrial Development Bank of India Act, 1964.
- (iii) Purchase or construction or sale of immovable property, so however, that no portion of income of the institution is derived from the financing of purchases, constructions or sales of immovable property by other persons.

30. Section 4A of the Companies Act, 1956 contains a list of institutions which are to be construed as “public financial institutions” for the purpose of the Act. The list is as follows:

- (i) the Industrial Credit and Investment Corporation of India Limited;
- (ii) the Industrial Finance Corporation of India;
- (iii) the Industrial Development Bank of India;
- (iv) the Life Insurance Corporation of India;
- (v) the Unit Trust of India;
- (vi) the Infrastructure Development Finance Company Limited;
- (vii) the securitisation company or the reconstruction company which has obtained a certificate of registration under sub-section (4) of section 3 of the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002.

31. Sub-section (2) of section 4A of the Act, subject to the provisions of sub-section (1) empowers the Central Government to notify in the Official gazette such other institution as it may think fit to be a public financial institution. In exercise of the powers conferred by sub-section (2), the Central Government has notified the following as public financial institutions:

- (i) The Industrial Reconstruction Bank of India established under the Industrial Reconstruction Bank of India Act, 1984.

- (ii) The General Insurance Corporation of India, formed and registered under the General Insurance Business (Nationalisation) Act, 1972.
- (iii) The National Insurance Company Limited, formed and registered under the Companies Act, 1956.
- (iv) The New India Assurance Company Limited, formed and registered under the Companies Act, 1956.
- (v) The Oriental Fire and General Insurance Company Limited, formed and registered under the Companies Act, 1956.
- (vi) The United Fire and General Insurance Company Limited, formed and registered under the Companies Act, 1956.
- (vii) The Shipping Company and Investment Company of India Limited.
- (viii) Tourism Finance Corporation of India Limited, formed and registered under the Companies Act, 1956.
- (ix) Risk Capital and Technology Finance Corporation Limited, formed and registered under the Companies Act, 1956.
- (x) Technology Development and Informations Company of India Limited, formed and registered under the Companies Act, 1956.
- (xi) Power Finance Corporation Limited, formed and registered under the Companies Act, 1956.
- (xii) National Housing Bank.
- (xiii) Small Industries Development Bank of India Limited established under the Small Industries Development Bank of India Act, 1989.
- (xiv) Rural Electrification Corporation Limited formed and registered under the Companies Act, 1956.
- (xv) Indian Railway Finance Corporation Limited, formed and registered under the Companies Act, 1956.
- (xvi) Industrial Finance Corporation of India Limited, formed and registered under the Companies Act, 1956.
- (xvii) Andhra Pradesh State Financial Corporation.
- (xviii) Assam Financial Corporation.
- (xix) Bihar State Financial Corporation.
- (xx) Delhi Financial Corporation.
- (xxi) Gujarat Financial Corporation.
- (xxii) Haryana Financial Corporation.
- (xxiii) Himachal Pradesh Financial Corporation.

- (xxiv) Jammu and Kashmir State Financial Corporation.
- (xxv) Karnataka State Financial Corporation.
- (xxvi) Kerala Financial Corporation.
- (xxvii) Madhya Pradesh Financial Corporation.
- (xxviii) Maharashtra State Financial Corporation.
- (xxix) Orissa State Financial Corporation.
- (xxx) Punjab Financial Corporation.
- (xxxi) Rajasthan Financial Corporation.
- (xxxii) Tamil Nadu Industrial Investment Corporation Limited.
- (xxxiii) Uttar Pradesh Financial Corporation.
- (xxxiv) West Bengal Financial Corporation.
- (xxxv) Indian Renewable Energy Development Agency Limited.
- (xxxvi) North Eastern Development Finance Corporation Limited.
- (xxxvii) Housing and Urban Development Corporation Limited.
- (xxxviii) Export and Import Bank of India
- (xxxix) National Bank for Agriculture and Rural Development.

32. The above-mentioned provisions of both the Acts should be considered while determining whether the loan granted to a company is from a financial institution.

Date of Coming into Force of the Order

33. The Order was issued in June 2003 and comes into force on the 1st day of July 2003. Further, the Order requires that every report made by the auditor under section 227 of the Act on the accounts of every company examined by him to which the Order applies, for every financial year ending on any day on or after the commencement of this Order, shall contain matters specified in paragraphs 4 and 5 of the Order. This implies that the auditor's report, on accounts in respect of financial year ending on or before 30th June 2003, even if issued on or after 1st July 2003 is required to contain report on matters specified in the erstwhile MAOCARO, 1988 and not on matters stated in this Order.

34. The Department of Company Affairs of the Government of India, subsequent to issuance of the Order has issued a Circular, GC No. 32/2003 on the date of compliance with the Order. According to the Circular, the

companies to whom the Order is applicable should make serious efforts to comply with the new Order from the effective date. The cases of non-compliance for accounts pertaining to financial year which closes on 31st December 2003 or earlier, Government would take a lenient view provided the accounts at least carry MAOCARO Report, if required. The circular, however, provides that accounts in respect of financial years ending on 1st January 2004 or thereafter, will have to strictly follow CARO, 2003. Companies and professionals who do not comply with the Order will be liable for action as per law. The Circular is reproduced in Appendix III.

35. The requirements of the Order apply in relation to full financial year irrespective of the fact that a part of such year may fall prior to the date of coming into force of the Order. Under some of the requirements of the Order, the auditor has to comment on the records maintained by the company, systems and procedures in vogue, etc. It is possible that during the period prior to 1st July 2003, many of the companies may not have maintained such records or established such systems and procedures as are envisaged in the Order primarily because the Order was not in force at the beginning of the financial year concerned or that certain clauses of the Order were not applicable to the company at the beginning of the financial year. It is advisable that in such situations, the auditor should also mention this fact while commenting on the relevant systems, procedures, etc.

Period of Compliance

36. A question may arise as to the period in relation to which the auditor should comment or report upon the matters specified in the Order. For example, several of the questions relate to the maintenance of proper records. What should be the position of the auditor when records were improperly maintained for some part of the accounting period but have been properly maintained at the balance sheet date? One view of the matter would be that no adverse report is necessary since the deficiencies existing during the year have been rectified before the auditor makes his report. However, this view does not recognise the fact that maintenance of records is not an end by itself but is a necessary condition for the auditor to satisfy himself regarding the authenticity of the transactions on which he is reporting. The better view, therefore, is to consider that the auditor is reporting on the state of affairs as they existed during the accounting year and compliance with the requirements of the Order should be judged with reference to the whole accounting year and not merely

with reference to the position existing at the balance sheet date or the date at which he makes his report. However, in deciding whether or not to make an adverse comment, the auditor should consider what ill effect, if any, has been caused by the failure to comply with the requirements of the Order for any part of the year. For example, if records for fixed assets were not properly maintained for some part of the year but were properly maintained at the balance sheet date and physical verification was made after the records were properly maintained, no ill effect has arisen. However, if internal control with respect to the items specified in the relevant clause of the Order was inadequate during a part of the year, some ill effect could have occurred.

37. At the same time, the auditor cannot ignore the position existing at the balance sheet date or at the time at which he makes his report. The auditor might consider, in the light of the circumstances and provided he is able to satisfy himself regarding the facts, as to whether a reference to the state of affairs existing at the balance sheet date or at the date when he makes his report would not give a more complete picture to the members to whom he is reporting.

38. It is not necessary that the auditor should refer individually to each of the transactions throughout the year where there has not been compliance with the requirements of the Order unless the non-compliance is so significant as to merit individual attention. Normally, it should be sufficient if he indicates in general terms whether or not the requirements have been complied with.

General Approach

39. In formulating a general approach to the requirements of the Order, it is necessary to take a view regarding the objective behind the issuance of the Order. The Order does not replace an audit by an investigation in respect of the matters specified therein. Several of these are matters which in any case are covered by an auditor in the normal course of his audit and the emphasis of the Order is not, therefore, on requiring the auditor to carry out an investigation but on requiring him to give specific information on certain aspects of his work.

40. The auditor should, in regard to the requirements of the Order, apply the same degree of examination, as he would do in a normal audit. Thus, the

degree of examination required should be such as is adequate to enable him to express an opinion on the matters referred to in the Order.

41. It is possible that for the purposes of the Order, the auditor may need greater information from the management; closer co-operation with the management, therefore, becomes necessary. This will ensure that there is sufficient advance planning regarding the manner in which the examination necessary under the Order will be carried out by the auditor and the form in which the company should keep its records so that they provide the necessary information and evidence to the auditor. An example of this would be the working papers to be maintained by the company to provide the requisite evidence to the auditor regarding verification of fixed assets or inventories. It is, therefore, suggested that the auditor intimate to the management in writing his requirements before the commencement of each audit.

42. For a number of reasons, the necessity for preserving working papers assumes greater importance in the context of the requirements of the Order. Firstly, there should be evidence that the opinion expressed by the auditor is based on an examination made by him. Secondly, there should be evidence to show that in arriving at his opinion, the auditor has given due cognisance to the information and explanations given by the company and that his opinion is not arbitrary. Thirdly, there should be evidence to show that the information and explanations obtained were full and complete, that is, the auditor has called for all the information and explanations which were necessary for the auditor to consider before arriving at his opinion. Finally, there should be evidence to show that the auditor did not merely rely upon the information or explanations given by the company but that he subjected such information and explanations to a reasonable test to verify their accuracy and completeness.

43. The auditor should comply with the requirements of Auditing and Assurance Standard (AAS) 3, "Documentation". The auditor should take, at least, the following steps to ensure that he has adequate working papers to support the conclusions drawn in his report:

- (a) submit to the company, a questionnaire on all important matters covered by the Order.
- (b) in addition, make specific inquiries in writing on all important matters not covered by the questionnaire.

- (c) insist that replies of the company are furnished in writing and are signed by a responsible officer of the company.
- (d) where the explanations are not already separately recorded, maintain a record of the discussions with the management.
- (e) prepare his own “check-list” in respect of the requirements of the Order and record there against the names of the members of his staff who made the examination and the names of the company’s staff who provided the information.

44. Where a requirement of the Order is not complied with but the auditor decides not to make an adverse comment, he should record in his working papers the reasons for not doing so, for example, the immateriality of the item.

45. The auditor should observe the requirements of the Order in its spirit and not merely by its letter. This implies that the auditor should not give a narrow or restrictive interpretation to the Order. Moreover, the mere fact that the Order is confined to certain specific matters should not be interpreted to imply that the auditor’s duties in respect of other matters normally covered in the course of an audit are in any way limited or abridged by the Order. At the same time, it should be recognised that the reporting obligations under the Order are confined to the specific items stated in the Order.

46. It is also necessary that in deciding upon the reasonableness of a course of action taken by the management, the auditor gives due consideration to the facts and circumstances existing when the decision was taken and the information known or available to the management at that time. He should not allow his judgement to be clouded by “hind-sight”. He should examine the transaction in the context of normal business operations and not in a theoretical or artificial set of circumstances.

47. Many of the matters covered by the Order require exercise of judgement by the auditor rather than the application of a purely objective test. For example, the auditor is required to state whether any material discrepancies noticed on physical verification of fixed assets have been properly dealt with in the accounts. This requires the exercise of judgement - firstly, in determining whether the discrepancies are material, and secondly, in deciding whether the accounting treatment is proper.

48. It is necessary to remember that the exercise of judgement is bound to be a somewhat subjective matter. This is, in fact, recognised by the provisions of the Act which require the expression of an opinion by the auditor. When a professional man expresses an opinion, he does not guarantee that his opinion is infallible nor does he hold out that his opinion will invariably agree with the opinion of another professional man on the same facts. The test of an auditor's liability in a matter which involves the exercise of judgement is not whether his opinion coincides with that of another person or authority, but whether he has expressed his opinion in good faith and after the exercise of reasonable care and skill. No liability can attach to an auditor in a matter involving the expression of an opinion based on the exercise of judgement, merely because there is a difference of opinion between him and some other person or authority or merely because some other person or authority comes to the conclusion that in expressing the opinion the auditor committed an error of judgement. The auditor may be liable, however, if it is found that he expressed his opinion without the exercise of reasonable care and skill, or without applying his mind to the facts, or if he expressed his opinion recklessly in complete disregard of the facts.

49. The Order places a considerable responsibility on the auditor. If he is to discharge his duties under the Order properly, he should obtain, on the one hand, the co-operation of the management and on the other, the respect and confidence of the members to whom he is reporting. He can do so if he makes his report honestly and fearlessly and if he brings to bear on his work, the professional qualities of independence, balance of judgement and fair-play which he possesses as a result of his education, training and experience.

Matters to be Included in the Auditor's Report

50. The matters to be included in the auditor's report are specified in paragraph 4 of the Order. Unlike in the earlier Order, which required different sets of statements for different classes of companies, the present Order is simple in its application to all companies irrespective of nature of business except those exempted from the application of the Order. However, in respect of nidhi/mutual benefit fund/societies, four additional sub-clauses under clause (xiii) are to be commented upon by the auditor. Further, clause (xiv) applies only to companies dealing in shares, securities etc.

51. *Whether the company is maintaining proper records showing full*

particulars, including quantitative details and situation of fixed assets.
[Paragraph 4(i)(a)]

Comments

- (a) The Order is silent as to what constitutes ‘proper records’. In general, however, the records relating to fixed assets should contain, *inter alia*, the following particulars:
 - (i) Sufficient description of the asset to make identification possible.
 - (ii) Classification, that is, the head under which it is shown in the accounts, e.g., plant and machinery, office equipment, etc.
 - (iii) Location.
 - (iv) Quantity, i.e., number of units.
 - (v) Original cost.
 - (vi) Year of purchase.
 - (vii) Adjustment for revaluation or for any increase or decrease in cost, e.g., on revaluation of foreign exchange liabilities.
 - (viii) Date of revaluation, if any.
 - (ix) Rate of depreciation.
 - (x) Depreciation for the current year.
 - (xi) Accumulated depreciation.
 - (xii) Particulars regarding sale, discarding, demolition, destruction, etc.
- (b) The records should contain the particulars in respect of all fixed assets, including those that have been fully depreciated.
- (c) It is necessary that the aggregate original cost and depreciation to date extracted from these records under individual heads should tally with the figures as shown in the books of account.
- (d) It is possible that the relevant details may not be available in respect of assets acquired prior to 1st April 1956. In fact, even Schedule VI to the Act provides that where the original cost cannot be ascertained, the book

value as at 1st April 1956 may be considered as cost. While the Order does not make this distinction, for the limited purpose of determining whether proper records are maintained, it should be considered as sufficient if, in respect of assets acquired prior to 1st April, 1956 where the original cost cannot be ascertained, the book value as on that date is considered as the cost.

- (e) The purpose of showing the location of the assets is to make verification possible. There may, however, be certain classes of fixed assets whose location keeps changing, for example, construction equipment which has to be moved to sites. In such circumstances, it should be sufficient if record of movement/custody of the equipment is maintained.
- (f) Where assets like furniture, etc., are located in the residential premises of members of the staff, the fixed assets register should indicate the name/designation of the person who has custody of the asset for the time being. In this connection, it may be necessary for the auditor to consider whether there are good reasons for the asset to be so located.
- (g) While, generally, the quantity, value and location have to be recorded item-wise, assets of small individual value, e.g., chairs, tables, etc., may be conveniently grouped for purposes of entry in the register. Similarly, for assets having a common rate of depreciation, it may not be necessary to indicate the accumulated depreciation for each item; instead, depreciation for the group as a whole may be shown.
- (h) It is not possible to specify any single form in which the records should be maintained. This would depend upon the mode of account keeping, for example manual or computerised, the number of operating locations, the systems of control, etc.
- (i) Quantitative details in respect of fixed assets may be maintained on the following lines:
 - (i) Land may be identified by survey numbers and by deeds of conveyance.
 - (ii) Leaseholds can be identified by individual leases.
 - (iii) Buildings may be initially divided into factory buildings, office buildings, township buildings, service buildings (like water works),

etc. These may then be further subdivided. Factory buildings may be broken down into individual buildings which house a manufacturing unit or a plant or sub-plant. Service buildings may be similarly broken down according to nature of service and location. Township buildings can be broken down into individual units or into groups of units taking into consideration the type of construction, the location and the year of construction. For example, if a company's township has four categories of quarters, e.g., A, B, C and D, the fixed assets register may not record each individual quarter but may have a single entry for all 'A' type quarters constructed in a particular year and located in a particular area and show only the number of quarters covered by the entry.

- (iv) Railway sidings can be identified by length and location.
- (v) Plant and Machinery may be sub-divided into fixed and movable. For movable machinery, a separate record may be kept for each individual item. Movable machinery would include, for this purpose, items of plant which are for the moment attached to the shop-floor but which can be moved, e.g., machine tools. In respect of fixed plant and machinery, a sub division can be made according to the process, a plant for each separate process being considered as a separate identifiable unit. A further sub-division may be useful when within a process; there are plants which are capable of working independently of each other. The degree to which a sub division of fixed plant and machinery should be made depends upon the circumstances of each case bearing in mind the twin objectives of sub-division, namely, the determination of individual cost and the facility for physical verification.
- (vi) The Act does not require electrical installations to be shown as a separate asset though a number of companies do so in fact. For purposes of identification, however, it is suggested that the initial sub-division may be made according to the user, e.g., factory buildings, plant, service departments, township buildings, etc. A further sub-division can be made according to the sub-division already made for buildings, plant, etc.
- (vii) Furniture and fittings and assets like office appliances, air-conditioners, water coolers, etc., consist of individual items which

can be easily identified. Some difficulty may, however, be faced with regard to the large number of items and their relative mobility. In such cases, a distinction by value may be necessary, individual identification being made for high-value items and by groups for other items.

- (viii) Development of property is an asset head which can be easily sub-divided according to the buildings or plant for which the development work was undertaken.
- (ix) Patents, trade marks and designs are normally identifiable by the purchase agreements or the letters granting patent and by registration references in case of trade marks and designs.
- (x) Vehicles can be identified by reference to the registration books.
- (j) The allocation of cost over identified units of assets, where such details are not already available, will have to be made by an analysis of the purchases and the disposals of the preceding years. Among the difficulties which may be faced could be: (i) records for some of the years may not be available; (ii) the description in the records may not be complete; (iii) details of disposals may not have been properly recorded; (iv) subsequent additions to an existing asset may have been shown as a separate asset; (v) a single figure of cost may be assigned to a number of assets which have to be separately identified; (vi) assets purchased for one department may have been moved to other departments, and so on. The management in consultation with the auditor should make the best effort possible under the circumstances of each company to identify the cost of each asset. In doing so, reasonable assumptions or approximations may be made, where necessary. For example, when details of disposals are not available, it may be assumed that the asset sold is the asset which was acquired earliest in point of time. Similarly, when the individual cost of a large number of small items is not available, one can estimate the cost of each item and pro-rate the total cost in the proportion of the estimated cost of the item to the aggregate estimated cost.
- (k) It may be useful if persons who are familiar with them, e.g., the maintenance staff, do the initial identification of the assets. At the point of identification, a code number may be affixed on the asset which would give sufficient details for future identification.

- (l) The initial identification of assets will often reveal a number of discrepancies between the assets as verified and the details compiled from the records. This may be on account of the features already considered in (j) above. This may also be due to the fact that assets may have been scrapped in earlier years but proper documentation may not have been made or that assets may have been broken up into smaller units or amalgamated into larger units or otherwise modified without changing the asset records. The degree of further inquiry necessary to reconcile these discrepancies would depend upon the nature of the asset, its cost, the age of the asset, the extent of accounting or other records available and other relevant factors. However, the concept of materiality should be borne in mind in making these further inquiries, greater attention being devoted to assets which are of large value or of relatively recent purchase. Any adjustments that finally have to be made should be properly documented. The auditor should request the appropriate level of management to carry out necessary adjustments.

52. 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. [Paragraph 4(i)(b)]

Comments

- (a) Physical verification of the assets has to be made by the management and not by the auditor. It is, however, necessary that the auditor satisfies himself that such verification was done and that there is adequate evidence on the basis of which he can arrive at such a conclusion. The auditor may prefer to observe the verification, particularly when verification of all assets can be made by the management on a single day or within a relatively short period of time. If, however, verification is a continuous process or if the auditor is not present when verification is made, then he should examine the instructions issued to the staff (which should, therefore, be in writing) by the management and should examine the working papers of the staff to substantiate the fact that verification was done and to determine the name and competence of the person who did the verification. In making this examination, it is necessary to ensure that the person making the verification had the necessary technical

knowledge where such knowledge is required. It is not necessary that only the company's staff should make verification. It is also possible for verification to be made by outside expert agencies engaged by the management for the purpose.

- (b) The auditor should examine whether the method of verification was reasonable in the circumstances relating to each asset. For example, in the case of certain process industries, verification by direct physical check may not be possible in the case of assets which are in continuous use or which are concealed within larger units. It would not be realistic to expect the management to suspend manufacturing operations merely to conduct a physical verification of the fixed assets, unless there are compelling reasons which would justify such an extreme procedure. In such cases, indirect evidence of the existence of the assets may suffice. For example, the very fact that an oil refinery is producing at normal levels of efficiency may be sufficient to indicate the existence of the various process units even where each such unit cannot be verified by physical or visual inspection. It may not be necessary to verify assets like building by measurement except where there is evidence of alteration/demolition. At the same time, in view of the possibility of encroachment, adverse possession, etc., it may be necessary for a survey to be made periodically of open land.
- (c) It is advisable that the assets are marked with "distinctive numbers" especially where assets are movable in nature and where verification of all assets is not being conducted at the same time.
- (d) The Order requires the auditor to report whether the management "at reasonable intervals" has verified the fixed assets. What constitutes "reasonable intervals" depends upon the circumstances of each case. The factors to be taken into consideration in this regard include the number of assets, the nature of assets, the relative value of assets, difficulty in verification, location and spread of the assets, etc. The management may decide about the periodicity of physical verification of fixed assets considering the above factors. While an annual verification may be reasonable, it may be impracticable to carry out the same in some cases. Even in such cases, the verification programme should be such that all assets are verified at least once in every three years. Where verification of all assets is not made during the year, it will be necessary for the auditor

to report that fact, but if he is satisfied regarding the frequency of verification he should also make a suitable comment to that effect.

- (e) The auditor is required to state whether any material discrepancies were noticed on verification and, if so, whether the same have been properly dealt with in the books of account. The latter part of the statement is required to be made only if the discrepancies are material. The auditor has, therefore, to use his judgement to determine whether a discrepancy is material or not. In making this judgement, the auditor should consider not merely the cost of the asset and its relationship to the total cost of all assets but also the nature of the asset, its location and other relevant factors. If a material discrepancy has been properly dealt with in the books of account (which may or may not imply a separate disclosure in the accounts depending on the circumstances of the case), it is not necessary for the auditor to give details of the discrepancy or of its treatment in the accounts but he is required to make a statement that a material discrepancy was noticed on the verification of fixed assets and that the same has been properly dealt with in the books of account.
- (f) Apart from the audit procedures mentioned above it would be appropriate for the auditor to obtain a management representation letter confirming that the fixed assets are physically verified by the company in accordance with the policy of the company. The management representation letter should also mention the periodicity of the physical verification of fixed assets. The letter should also include the details of the material discrepancies noticed during the physical verification of the fixed assets.

53. *If a substantial part of fixed assets have been disposed off during the year, whether it has affected the going concern. [Paragraph 4(i)(c)]*³

Comments

- (a) Auditing and Assurance Standard (AAS) 16, 'Going Concern', requires that when planning and performing audit procedures and in evaluating the results thereof, the auditor should to consider the appropriateness of the going concern assumption underlying the preparation of financial statements. The clause requires the auditor to specifically consider the risk

³ The erstwhile MAOCARO, 1988 did not contain this clause.

that the going concern assumption might have been affected due to disposal of a substantial part of the fixed assets of a company. Therefore, the comments under this clause are restricted to the additional audit procedures that the auditor should perform to obtain sufficient appropriate audit evidence to resolve the going concern assumption in this particular situation. The requirements of Auditing and Assurance Standard (AAS), “Going Concern” shall apply *mutatis mutandis* to this clause.

- (b) The Order does not define the word “substantial”. The issue as to what constitutes “substantial part of fixed assets” depends primarily upon on the facts and circumstances of each case. However, an asset is considered to be a “substantial part of fixed assets” if the absence of that part of the fixed assets may result in the going concern assumption becoming questionable.
- (c) The auditor should examine whether the company has disposed off any fixed asset during the accounting period covered by his report. If yes, the auditor should consider whether the disposal of such part of the fixed assets has created the risk of going concern assumption being no longer appropriate. It is possible that such risk is mitigated by factors such as the management’s plan to adopt a more profitable line of business, or where the sale of fixed assets is for generating funds for fresh acquisition of fixed assets.
- (d) The auditor should carry out audit procedures to gather sufficient appropriate audit evidence to satisfy him self that the company shall be able to continue as a going concern for the foreseeable future despite the sale of such part of fixed assets. These procedures may include:
 - (i) analysis of the importance and discussion with the management as to the significance of the fixed asset to the company as a whole;
 - (ii) reading the minutes of the meetings of the board of directors and important committees for understanding the entity’s business plans for the future (for example, replacement of the fixed asset with another fixed asset having more capacity);
 - (iii) review of events after the balance sheet date for analysing the effect of disposal of fixed asset on the going concern.

- (e) The auditor should also obtain sufficient appropriate audit evidence that the plans of the management are feasible, are likely to be implemented and that the outcome of these plans would improve the situation. Apart from this, the auditor should also seek written representations from the management in this regard.

54. *Whether physical verification of inventory has been conducted at reasonable intervals by the management.* [Paragraph 4(ii)(a)]⁴

Comments

- (a) The clause requires the auditor to comment whether the management conducts physical verification of inventory at reasonable intervals. According to Accounting Standard (AS) 2, Valuation of Inventories:

“Inventories are assets:

- (a) held for sale in the ordinary course of business;
 - (b) in the process of production for such sale; or
 - (c) in the form of materials or supplies to be consumed in the production process or in the rendering of services.”
- (b) Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, consumables and loose tools awaiting use in the production process. Inventories do not include machinery spares which can be used only in connection with an item of fixed asset and whose use is expected to be irregular.
- (c) Physical verification of inventory is the responsibility of the management of the company which should verify all material items at least once in a year and more often in appropriate cases. It is, however, necessary that the auditor satisfy himself that the physical verification of inventories has been conducted at reasonable intervals by the management and that there is adequate evidence on the basis of which the auditor can reach at such a

⁴ The earlier Order contained a similar clause, except that the words used in place of “inventory” were “finished goods, stores, spare parts and raw materials”.

conclusion.

- (d) What constitutes “reasonable intervals” depends on circumstances of each case. The periodicity of the physical verification of inventories depends upon the nature of inventories, their location and the feasibility of conducting a physical verification. The management of a company normally decides the periodicity of the physical verification of inventories considering these factors. Normally, wherever practicable, all the items of inventories should be verified by the company at least once in a year. It may be useful for the company to determine the frequency of verification by ‘A-B-C’ classification of inventories, ‘A’ category items being verified more frequently than ‘B’ category and the latter more frequently than ‘C’ category items.
- (e) The auditor should evaluate the reasonableness of the periodicity of the physical verification of inventories in the light of above-mentioned factors. The auditor, in order to substantiate, that the management conducts physical verification of inventories at reasonable interval, applies the following audit procedures in respect of physical verification carried out during an interval:
 - (i) verification of the written instructions given by the management to the concerned staff engaged in the verification process;
 - (ii) verification of the physical verification of inventory sheets duly authenticated by the field staff and responsible officials of the company;
 - (iii) verification of the summary sheets/consolidation sheets duly authenticated by the responsible officials;
 - (iv) examination of internal memos etc., regarding the issues arising out of physical verification of inventory; and
 - (v) examination of any other relevant documents evidencing physical verification of inventory.

55. *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 its business? If not, the inadequacies in such*

procedures should be reported. [Paragraph 4(ii)(b)]

Comments

- (a) This clause requires the auditor to comment on the reasonableness and adequacy of the inventory verification procedures followed by the management of the company. In case the procedures of physical verification of inventories, in the opinion of the auditor, are not reasonable and adequate in relation to the size of the company and the nature of its business, he has to report the inadequacies also. The term “inventory” should be construed to have the same meaning as is assigned to it in Accounting Standard (AS) 2, Valuation of Inventories.
- (b) While the physical verification of inventories is primarily the duty of the management, the auditor is expected to examine the methods and procedures of such verification. The auditor should establish the reasonableness and adequacy of procedures adopted for physical verification of inventories having regard to the nature of inventories, their locations, quantities and feasibility of conducting the physical verification. This would require the auditor to make use of his professional judgement.
- (c) There are two principal methods of physical verification of inventories: periodic and continuous. Under the periodic physical verification method, physical verification of inventories is carried out at a single point of time, usually at the year-end or at a selected date before or shortly after the year-end. Under the continuous physical verification method, physical verification is carried out throughout the year, with different items of inventory being physically verified at different points of time. However, the verification programme is normally so designed that each material item is physically verified at least once in a year and more often in appropriate cases. The continuous physical verification method is effective when a perpetual inventory system of record-keeping is also in existence. Some entities use continuous physical verification methods for certain stocks and carry out a full count of other stocks at a selected date.
- (d) Normally, before commencement of verification, the management should issue appropriate instructions to stock-taking personnel. Such instructions should cover all phases of physical verification and preferably be in writing. It would be useful if the instructions are formulated by the entity

in consultation with the auditor. The auditor should examine these instructions to assess their efficacy.

- (e) The auditor should ascertain whether the management has instituted adequate cut-off procedures. For example, he may examine a sample of documents evidencing the movement of inventories into and out of stores, including documents pertaining to periods shortly before and shortly after the cut-off date, and check whether the inventories represented by those documents were included or excluded, as appropriate, during the stock-taking.
- (f) The auditor should review the original physical verification sheets and trace selected items - including the more valuable ones - into the final inventories. He should also compare the final inventories with stock records and other corroborative evidence, e.g. inventory statements submitted to banks.
- (g) Where continuous stock-taking methods are being used by the entity, the auditor should, in addition to performing the audit procedures discussed above, pay greater attention to ascertaining whether the management:
 - (i) maintains adequate stock records that are kept up-to-date;
 - (ii) has established adequate procedures for physical verification of inventories, so that in the normal circumstances, the programme of physical verification will cover all material items of inventory at least once during the year; and
 - (iii) investigates and corrects all material differences between the book records and the physical counts.
- (h) The auditor should determine whether the procedures for identifying damaged and obsolete items of inventory operate properly.
- (i) The auditor, under this clause, is required to determine the reasonableness and adequacy of the procedures of physical verification of inventories followed by the management. The auditor may do so by examining the records and documents related to the physical verification of inventories. These records and documents would also include the policy of the company regarding physical verification. In case where the inventories are material and the auditor is placing reliance on the records, documents

information and explanations provided by the management, it would be desirable that the auditor, in order to substantiate the fact that the physical verification is carried out in accordance with the procedure explained by the management attends the physical verification. Where the auditor is present at the time of stock-taking, he should observe the procedure of physical verification adopted by the stock-taking personnel to ensure that the instructions issued in this behalf are being actually followed. The auditor should also perform test-counts to satisfy himself about the effectiveness of the count procedures. In carrying out the test counts, the auditor should give particular consideration to those inventories which have a high value either individually or as a category of inventories.

- (j) While commenting on this clause, the auditor should point out the specific areas where he believes the procedure of inventory verification is not reasonable or adequate.

56. 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 have been properly dealt with in the books of account. [Paragraph 4(ii)(c)]

Comments

- (a) This clause is almost identical with the corresponding clause of MAOCARO, 1988 except that the opening words i.e., “whether the company is maintaining proper records of inventory” have been added.
- (b) What constitutes “proper records” has not been defined. However, in general, records relating to inventories should contain, among other things, the following particulars:
 - (i) details regarding dates of transactions;
 - (ii) relevant document number and department identification, if any;
 - (iii) identification code of the item;
 - (iv) quantity of the receipts and issues and balances;
 - (v) physical verification quantities;

- (vi) location;
- (vii) valuation details; etc.
- (c) The records should contain the particulars in respect of all items of inventories. The auditor should also satisfy himself that the stock registers are updated as and when the transactions occur. The auditor should also verify that the transactions entered in stock registers are duly supported by relevant documents.
- (d) It is necessary that the values of inventories extracted from these records under individual heads should tally with the figures as shown in the books of account.
- (e) The purpose of showing the location of the inventory is to make verification possible. The record of movement/custody of the inventory should be maintained.
- (f) It is not possible to specify any single form in which the records should be maintained. This would depend upon the mode of account-keeping, for example manual or computerised, the number of operating locations, the systems of control, etc.
- (g) The Order further requires the auditor to examine if material discrepancies have been noticed on verification of inventories when compared with book records. Such an examination is possible when quantity records are maintained but there are many companies where records of individual issues (particularly for stores items) are not separately maintained and the closing inventory is established only on the basis of a year-end physical verification. Where such day-to-day records are not maintained, the auditor will not be able to arrive at book inventories except on the basis of an annual reconciliation of opening inventory, purchases and consumption. This reconciliation is possible when consumption in units can be co-related to the production, or can be established with reasonable accuracy. Where such reconciliation is not possible, the auditor would be unable to determine the discrepancies. If the item for which the discrepancy cannot be established is not material, the discrepancy, if any, will also not be material. In other cases, however, the auditor will have to report that he is unable to determine the discrepancy, if any, on physical verification for the item or class of items to be specified.

57. Has the company either granted or taken any loans, secured or unsecured to/from companies, firms or other parties in the register maintained under section 301 of the Act. If so, give the number of parties and amount involved in the transactions. [Paragraph 4 (iii)(a)]

Comments

- (a) The clause requires that the auditor's report should disclose the "number of parties" and "amount involved" in case a company has 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. MAOCARO, 1988 did not require a complete list of number of parties and amount involved in the loans taken/granted from/to companies, firms or other parties covered in the register maintained under section 301 of the Act.
- (b) The auditor is required to disclose the requisite information in his report in respect of all such parties even if the rate of interest and other terms and conditions are not prejudicial to the interest of the company.
- (c) The auditor should obtain a list of companies, firms or other parties in the register maintained under section 301 of the Act from the management. The auditor should examine all loans (secured or unsecured) granted or taken by the company to identify those loans granted or taken to/from companies, firms or other parties in the register maintained under section 301 of the Act.
- (d) It may so happen that a party listed in the register maintained under section 301 of the Act may take a loan from the company and repays it to the company during the financial year concerned. Similar situation may exist in the case of loans taken by the company. Therefore, while examining the loans, the auditor should also take into consideration the loan transactions that have been squared up during the year and also report such transactions under the clause. For example, the company has, during the financial year, granted a loan of Rs. 1,00,000/-to a firm in which the directors of the company are interested and the firm repays the loan during the financial year concerned, the auditor in such a situation should give the particulars in the format suggested below with the year end balance shown as nil.
- (e) Although the clause requires the auditor to mention the number of parties

and amounts involved, it is suggested that the name of the party and its relationship with the company are also mentioned in the report. The auditor should report the information so gathered in the following format:

Details of Loans Taken				
<i>Sly. No.</i>	<i>Name of the Party</i>	<i>Relationship with the company</i>	<i>Amount (Rs.)</i>	<i>Year end balance</i>
Details of Loans Granted				
<i>Sly. No.</i>	<i>Name of the Party</i>	<i>Relationship with the company</i>	<i>Amount (Rs.)</i>	<i>Year end balance</i>

58. *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. [Paragraph 4 (iii)(b)]*⁵

Comments

- (a) This clause requires the auditor to comment on the rate of interest and other terms and conditions of loans given or taken by the company (whether secured or unsecured) to companies, firms or other parties listed in the Register maintained under Section 301 of the Act.
- (b) The auditor should examine the rate of interest and other terms and conditions of all loans taken or granted by the company to/from companies, firms or other parties listed in the Register maintained under Section 301 of the Act. The nature of the interest, of course, cannot be other than the nature of interest covered in Section 301. For example, the mere fact that a director is a shareholder in a public limited company will not mean that he is interested unless of course he, together with other directors, holds 2% or more of the share capital.
- (c) The auditor's duty is to determine whether, in his opinion, the rate of interest and other terms and conditions of the loans are *prima facie* prejudicial to the interest of the company. The "other terms" would primarily include security, terms and period of repayment and restrictive

⁵ This clause is similar to the corresponding sub-clauses under the erstwhile MAOCARO, 1988 except that the new clause does not cover transactions with companies under the same management as defined under sub-section (1B) of Section 370.

covenants. In determining whether the terms of the loans are “*prima facie*” prejudicial, the auditor would have to give due consideration to a number of factors connected with the loan, including the company’s financial standing, its ability to borrow/lend, the nature of the security, the availability of alternative sources of finance, the urgency of the borrowing, purpose of the loan, prevailing market rate of interest and so on. The auditor may well come to the conclusion that better terms could have been obtained but unless the difference in the terms which have been obtained and the terms which could have been obtained is so significant that no reasonable person would have accepted the loan on the terms on which the loan has been accepted, it would be difficult for the auditor to conclude that the terms are prejudicial.

- (d) If the auditor finds that better terms could have been obtained in respect of loans taken or granted, the auditor should obtain the company’s explanation in writing as to why the company considers that the terms obtained are not prejudicial to the interest of the company. If the auditor does not find the explanation convincing, it will be necessary for him to state that the terms obtained by the company have been prejudicial to its interest.
- (e) It may be mentioned that clause (a) of sub-section (1A) of Section 227 of the Act also requires the auditor to inquire whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members. The auditor’s inquiry under the aforesaid clause may also be useful for the purposes of reporting under this clause.

59. *Whether the payment of principal amount and interest are also regular.* [Paragraph 4 (iii)(c)]⁶

Comments

- (a) The clause requires the auditor to report upon the regularity of repayment of principal amount of loans and interest. This covers both loans granted and taken by the company to parties covered under section 301 of the Act.

⁶ The corresponding clause of the erstwhile MAOCARO, 1988 required the auditor to make an inquiry regarding loans as well as advances in the nature of loans.

- (b) The auditor's inquiry under this clause is restricted to loans granted/taken by the company. However, there could be situations in which advances made by a company, in substance, would be in the nature of loans. Whether an advance is in the nature of a loan would depend upon the circumstances of each case. For example, a normal advance against an order, in accordance with the normal trade practice, would not be an advance in the nature of a loan. But if an advance is given for a figure which is far in excess of the value of an order or for a period which is far in excess of the period for which such advances are usually extended as per the normal trade practice, then such an advance may be in the nature of a loan to the extent of such excess. When a trade practice does not exist, a useful guide would be to consider the period of time required by the supplier for the execution of the order, that is, the time between the purchase of the raw material and the delivery of the finished product. An advance which exceeds this period, would normally be an advance in the nature of a loan unless there is evidence to the contrary. Similarly, a stipulation regarding interest may normally be an indication that the advance is in the nature of a loan but this by itself is not conclusive and there may also be advances which are not in the nature of a loan and which carry interest. The auditor while reporting on this clause should also cover advances which are in the nature of loans.
- (c) The auditor has to examine whether the payment of principal and interest is regular. The word 'regular' should be taken to mean that the principal and interest should be paid when it falls due or immediately thereafter. If a due date for payment of principal or interest is not specified, it would be reasonable to assume that it falls due on each anniversary of the loan.
- (d) Where no stipulation has been made for the repayment of the loan or the payment of the interest or both, the auditor is not in a position to make any specific comments. However, the auditor state the fact that he has not made any comments because the terms of repayment and/or interest have not been specified.
- (e) The following are the procedures that the auditor should follow to report on the clause:
 - (i) the auditor, while obtaining an understanding of the terms and conditions for reporting under Paragraph 4 (iii)(b) should also take note of repayment schedule;

- (ii) if loan agreements are not executed, any other equivalent documents may be referred to arrive at the terms of repayment and payment of interest;
- (iii) the dates of repayment of principal and payment of interest needs to be verified with reference to the books of accounts of the company to come to the conclusion whether the repayments of principal and payment of interest are regular; and
- (iv) if the results of the procedures mentioned above indicate any irregularity in payment of principal and/or interest the auditor should disclose the necessary particulars in his report in the following format⁷:

<i>Sly. No.</i>	<i>Name of the Party</i>	<i>Overdue Principal</i>	<i>Overdue Interest</i>	<i>Year end balance</i>
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60. *If overdue amount is more than one lakh, whether reasonable steps have been taken by the company for recovery/payment of the principal and interest. [Paragraph (iii)(d)]*

Comments

- (a) The clause requires the auditor to state whether reasonable steps have been taken by the company for recovery/payment of the principal and interest, wherever the overdue amount is more than one lakh rupees. Where the overdue amount is more than one lakh rupees and the repayment of loan is not made as stipulated or where interest is not paid regularly, the auditor has to examine the steps, if any, taken for recovery/repayment of this amount.
- (b) In making this examination, the auditor would have to consider the facts and circumstances of each case, including the amounts involved. It is not necessary that steps to be taken must necessarily be legal steps. Depending upon the circumstances, the degree of delay in recovery/repayment and other similar factors, issue of reminders or the sending of an advocate's or solicitor's notice, may amount to "reasonable

⁷ The format can be used in respect of loans granted as well as loans taken by the company.

steps” even though no legal action is taken. The auditor is not, therefore, required to comment adversely on the mere absence of legal steps if he is otherwise satisfied that reasonable steps have been taken by the company. The auditor should ask the management to give in writing the steps which have been taken. The auditor should arrive at his opinion only after consideration of the management’s representations.

- (c) In respect of loans granted, reasonable steps for recovery, normally, include regular follow-up with the borrowers, serving of legal notices, partial recovery periodically and other efforts put in by the company to recover the amounts.
- (d) In respect of loans taken, reasonable steps to repay principal and interest may include arrangement for raising finances, restructuring proposals, arrangements with the lenders for compromise proposals, partial repayment etc.
- (e) The auditor should obtain sufficient appropriate audit evidence to support the fact that reasonable steps have been taken for repayment/recovery of the principal and interest of loans taken/granted by the company.
- (f) In cases where the auditor is not satisfied about the reasonability of steps, in respect of any party, the auditor should report the name of the party, overdue amount of principal and interest.

61. *Is there an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the purpose of inventory and fixed assets and for the sale of goods? Whether there is a continuing failure to correct major weaknesses in internal control.* [Paragraph 4(iv)]⁸

Comments

- (a) The clause requires the auditor to comment whether there is an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the purpose of inventory and fixed assets and for the sale of goods. The clause also requires the auditor to report whether there is a continuing failure by the company to correct the

⁸ The clause is almost similar to the corresponding clause of MAOCARO, 1988 except that the word “inventory” has been used in the Order in place of “raw materials...”

major weaknesses in the internal control. The term “inventory” should be construed to have the same meaning as is assigned to it in Accounting Standard (AS) 2, Valuation of Inventories.

- (b) Examination of the system of internal control is a normal audit procedure. While the requirement of the Order is confined only to internal control procedures regarding purchase of inventory, fixed assets and sale of goods, it does not mean that the requirement on the part of the auditor to examine internal control with regard to other areas is in any way diminished. It only means that special emphasis has to be given to the examination of internal control procedures with regard to purchases and sales of the items specified.
- (b) The system of internal control is the plan of organisation and all the methods and procedures adopted by the management of an entity to assist in achieving management’s objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, prevention and detection of fraud and error, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.
- (c) There are a number of methods by which the system of internal control can be studied and evaluated, for example, flow-charts, questionnaires, etc. Use of any one of these methods does not preclude the use of the other and the auditor is free to select any one or more of the methods that he considers best suited to the circumstances of the case. Irrespective of the method selected, it is necessary that the auditor maintains sufficient documentation regarding his study and evaluation of the internal control system. In this regard, attention is invited to the Auditing and Assurance Standard (AAS) 6, “Risk Assessments and Internal Control” issued by the Institute.
- (d) In making the evaluation, the auditor has to give due regard not merely to the size of the company and the nature of its business but also to the organisational structure. This suggests that whereas internal control may be absolutely essential for a large company with a diversified business operating at several locations, internal control may be less formal in an “owner-managed” or a small company where there is a greater degree of personal supervision.

- (e) An illustrative list of questions which may be used by the auditor in evaluating the internal controls in regard to purchase of inventory, fixed assets and sale of goods are given in Appendix IV.
- (d) The sub-clause also requires the auditor to comment whether there is a continuing failure to correct major weaknesses in internal control. The auditor, for reporting on this sub-clause, would have to ascertain the weaknesses in the internal controls that are in the knowledge of the management and then examining whether there is a continuing failure to correct major weaknesses.
- (e) What constitutes “major weakness” depends upon the facts and circumstances of each case. The auditor should use his professional judgement in this regard. Ordinarily, any weakness that is capable of resulting in a breach of the internal controls is considered to be a major weakness and therefore, comes within the ambit of reporting under this sub-clause. The auditor should, however, recognise that some weaknesses are of such nature that individually they may not seem to be “major” but when evaluated along with others might become material for the purpose of the auditor.
- (f) The determination as to what constitutes “continuing failure” is a matter that requires use of professional judgement by the auditor. Normally, if a weakness is not found to be corrected on an assessment of the correction of the same, it is considered that there is a “failure” to correct the weakness. When the failure, which existed on the previous assessment of the correction, continues to persist on the current assessment is considered to be “continuing failure”. It may, however, be noted that the existence of continuing failure is important for reporting on this sub-clause. Even if the management has taken reasonable steps to correct the weakness but the weakness continues, the auditor is required to report the same.
- (g) The auditor should review the reports of internal auditor, if any. The reports of internal auditors may point out cases of weaknesses in the design of internal controls and non-observance of the laid down controls. The auditor should also review his previous years’ working papers to determine the weaknesses in the internal controls already communicated to the management. It may be noted that paragraph 50 of Auditing and Assurance Standard (AAS) 6, “Risk Assessments and Internal Controls” requires that the auditor should make management aware, as soon as

practical and at an appropriate level of responsibility, of material weaknesses in the design or operation of the accounting and internal control systems, which have come to the auditor's attention during the course of the audit. The auditor should examine the follow-up actions taken by the management in response to weaknesses communicated to it.

- (h) On an evaluation of the results of his examination of the follow-up actions, if the auditor is of the opinion that the weakness known to the management persists, apart from stating that there is a continuing failure to correct major weakness, the should report the weakness and the steps taken by the management to correct the weakness, if any. Where the management has not taken any steps for correcting the weakness, the auditor's report should also state this fact.
- (i) In case there is a continuing failure on the part of the company to correct major weakness in the internal controls, the auditor should also make a re-assessment of the control risk, at the assertion level, for each material account balance or class of transactions so that appropriate audit procedures can be designed to reduce the overall audit risk to an acceptably low level. Further, if the auditor is of the opinion that the major weaknesses in the internal control have serious implications on the adequacy or reliability of the books of account of the company, the auditor should consider modifying his audit report on the financial statements. Where the auditor decides to do so, he should comply with the requirements of the Auditing and Assurance Standard (AAS) 28, "The Auditor's Report on the Financial Statements" in this regard.

62. *Whether transactions that need to be entered into a register in pursuance of section 301 of the Act have been so entered.* [Paragraph 4(v)(a)]⁹

Comments

- (a) The clause requires that the auditor should report whether the transactions that need to be entered into a register in pursuance of Section 301 of the Act have been so entered.

⁹ The earlier Order did not contain this clause.

- (b) The auditor should obtain a listing of companies, firms or other parties the particulars of whom are required to be entered in the register maintained under section 301 of the Act. The auditor should also obtain a written representation from the management concerning the completeness of the information so provided to the auditor. The auditor should review the information provided by the management and should perform the following procedures in respect of the completeness of this information:
- (i) review his working papers for the prior years for names of known companies, firms or other parties the particulars of whom are required to be entered in the register maintained under section 301 of the Act;
 - (ii) review the entity's procedures for identification of companies, firms or other parties the particulars of whom are required to be entered in the register maintained under section 301 of the Act;
 - (iii) inquire as to the affiliation of directors and key management personnel, officers with other entities;
 - (iv) review shareholder records to determine the names of principal shareholders or, if appropriate, obtain a list of principal shareholders from the share register;
 - (v) review the entity's income tax returns and other information supplied to regulatory agencies; and
 - (vi) review the joint venture and other relevant agreements entered into by the entity.
- (c) The auditor should verify, on the basis of information provided by the management and on the basis of the results of the procedures performed by him, whether transactions that need to be entered into a register in pursuance of section 301 of the Act have been so entered or not. The auditor also evaluates whether the registers under section 301 are updated and maintained properly.
- (d) In case the company has not properly maintained the register required to be maintained by it under Section 301, the auditor, while reporting on this clause, should clearly mention the fact of non-maintenance/improper maintenance of the aforesaid register.

63. *Whether each of these transactions have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time. [Paragraph 4(v)(b)]*¹⁰

Comments

- (a) The new clause is almost identical in intention compared to the earlier Order. It requires the auditor to comment upon reasonableness of the prices of all kinds of transactions which have been entered in pursuance of contracts or arrangements entered in the register(s) maintained under Section 301 of the Act. The reasonableness of the prices is, however, required to be determined only in respect of transactions that exceed the value of Rs. 5,00,000/- in respect of any party and in any one financial year.
- (b) It may also be noted that section 301 pertains to contracts or arrangements in which the directors are interested. It is important to note that the clause does not cover transactions of purchase and sale with subsidiaries except where one or more of the directors of the company are interested in the subsidiary in which case the transaction may have been made in pursuance of a contract or arrangement entered in the register maintained under Section 301.
- (c) The auditor has to examine whether the prices paid for the transactions examined by him are reasonable having regard to the prevailing market prices at the relevant time. The auditor is not expected to make a roving market inquiry to determine the market prices prevailing at the time the transactions of purchase or sale were entered into. However, he may examine information such as price lists, quotations, and records relating to prices at which similar transactions have been entered into with other parties, etc at the relevant time. The auditor has to satisfy himself, taking into account all the relevant information as well as any explanations given by the management, whether the prices at which transactions of purchase

¹⁰ The corresponding clause of the erstwhile MAOCARO, 1988 required the auditor to comment upon reasonableness of the prices of purchase of goods and materials and sale of goods, materials and services, made in pursuance of contracts or arrangements entered in the register(s) maintained under Section 301 of the Act having regard to prevailing market prices for such goods, materials, or services or the prices at which transactions for similar goods or services have been made with other parties. The scope of transactions, which were required to be scrutinised, was limited to purchase of goods and material and sale of goods, materials and services, made in pursuance of contracts or arrangements entered in the register(s) maintained under Section 301 of the Companies Act, 1956. Further, the reasonableness was to be determined for transactions that aggregated to Rs. 50,000/- (rupees fifty thousand) or more during the year in respect of each party.

and sale have been made are, *prima facie*, reasonable. In determining the reasonableness of the prices, the auditor should take into account all the factors surrounding the transactions of purchase or sale such as the delivery period/schedule of implementation, the quality of the product/service, the quantity, the credit terms, the previous record of supplier/buyer/client, etc. For example, in a transaction of purchase, it is not necessary that purchases be made in all cases at the lowest rates. When the rates paid are higher than the prevailing market prices, the auditor has to use his judgement to determine whether the difference in rates is reasonable having regard to the other factors mentioned above. This may often be the case where the company wishes to have more than one source of supply or where there is limit to the manufacturing capacity of the supplier who quotes the lower price.

- (d) A difficulty in judging the reasonableness of prices may arise in cases where truncations are entered with sole suppliers. In such cases, the auditor may examine the reasonableness of prices paid with reference to list prices of the supplier concerned, other trade terms of the supplier, etc.
- (e) There may be situations where the company has not properly maintained the register required to be maintained by it under Section 301. In such situations, the auditor should clearly mention the fact of non-maintenance/improper maintenance of the aforesaid register, while reporting on this clause.

64. *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 whether the same has been complied with or not?* [Paragraph 4 (vi)]

Comments

- (a) The clause substantially resembles the corresponding clause under MAOCARO, 1988 except that the new clause requires the auditor to
 - (i) report on compliance with the provisions of section 58AA of the Act in case the company has accepted public deposits; and

- (ii) report on compliance with directions passed by the Company Law Board, if any, pursuant to contravention of the relevant provisions.
- (b) Section 58A of the Act gives power to the Central Government to prescribe, in consultation with the Reserve Bank of India, the limits up to which, the manner in which and the conditions subject to which deposits may be invited or accepted by a company either from the public or from its members. The section does not apply to a banking company or to such other company as the Central Government may, after consultation with the Reserve Bank of India, specify in that behalf.
- (c) On 3rd February 1975, the Central Government issued the Companies (Acceptance of Deposits) Rules, 1975. The Rules apply only to such companies as are not banking companies and are also not financial companies. Thus, financial companies are not covered by the Rules. Such companies continue to be governed by the directives issued by the Reserve Bank of India.
- (d) The Rules cover the following main items:
 - (i) the form of deposits which may be accepted and the terms thereof;
 - (ii) the limits up to which the deposits can be accepted;
 - (iii) the form and particulars of advertisement for deposits;
 - (iv) the form of application for deposits;
 - (v) the furnishing of receipts to depositors;
 - (vi) the maintenance of registers of depositors;
 - (vii) the general provisions regarding the repayment of deposits and payment of interest;
 - (viii) the returns to be filed with the Registrar of Companies and the Reserve Bank of India.
- (e) Section 58AA was introduced with effect from 13th December 2000 inserted by the Companies (Amendment) Act, 2000. The section deals with small depositors. According to the section, a small depositor has been defined according to the section, as a depositor who has deposited in

a financial year a sum not exceeding twenty thousand rupees in a company. The section lays down certain requirements to be complied with by the companies which have accepted deposits from such small depositors. Audit considerations similar to those that have been mentioned for section 58A would apply in regard section 58AA also.

- (f) The auditor should plan to test for compliance with the provisions of section 58A, 58AA, and the relevant rules. Before planning for the test of compliance, the auditor should obtain a general understanding of section 58A, 58AA, and the relevant rules and should also ascertain how the company is complying with the provisions of section 58A, 58AA, and the relevant rules.
- (g) The auditor should make plans to examine compliance with regard to all the matters specified in the sections and Rules and not merely to the limits of the deposits. Where the number of deposits is very large, it is obviously not feasible for the auditor to satisfy himself that every single deposit complies with the rules. He should, therefore, examine the system by which deposits are accepted and records are maintained and make a reasonable test check to ensure that the system operates. He would also be well-advised to make a “check list” to ensure that all the requirements of the Rules regarding the records to be maintained, returns to be filed, etc., are complied with.
- (h) The auditor should examine the efficacy of the internal controls instituted by the company so that the deposits accepted by the company remain within the limits. It may be difficult for the auditor to ascertain that deposits accepted by the company are within the limits on each day of the accounting year. He would, therefore, be justified in making a reasonable test check to ensure that the company has not accepted deposits during the year in excess of the limits. For financial companies, the auditor should make a similar examination having regard to the Reserve Bank directives in force from time to time¹¹.
- (i) Non-compliance of section 58AA would occur on the even when a company fails to intimate the Tribunal any default in repayment of deposit

¹¹ Reference may be made in this regard to the Guidance Note on the Duty Cast on the Auditors under Section 45MA of the Reserve Bank of India Act, 1934, reproduced in Volume II of Handbook of Auditing Pronouncements (Compendium of Guidance Notes).

made by small investors or part thereof or any interest thereupon. The auditor has to, therefore, first determine whether there is a default in any repayment. This would require the auditor to examine all the accounts related to small investors. In case where a company has large number of deposits accepted from small depositors, it may not be feasible for the auditor to first verify each account for default in repayment and then check whether the company has complied with the requirements of section 58AA of the Act. The auditor in such a case should examine the internal control in place in this regard and determine its efficacy. The auditor, thereafter, should make reasonable test checks in this regard.

- (j) Apart from the audit procedures mentioned above, the auditor should also enquire of the management of the company about the possible instances of non-compliance with section 58A, 58AA and relevant rules. The auditor should also enquire of the management about any order passed by the [Company Law Board]¹² for contravention of section 58A, 58AA and the Rules. The auditor should also examine the correspondence and documents filed with the Registrar of Companies to ascertain whether there is any contravention or whether the Company Law Board has passed an order.
- (k) Where an order has been passed by the CLB, the auditor should examine the steps taken by the company to comply with the order.
- (l) The auditor is required to report about the nature of contraventions in case the company has not complied with the relevant directives of the Reserve Bank of India or the provisions of Section 58A or with the provisions of section 58AA of the Companies Act, 1956 and the Rules framed there under.¹³
- (m) The auditor has to also examine records in connection with the deposits regarding matters which the Company Law Board has dealt with. In such case, the auditor is required under this clause to verify whether the company has complied with the order passed by Company Law Board. If not, the same is to be reported briefly stating therein the nature of

¹² The term "Company Law Board" has been substituted by the term "National Company Law Tribunal" by the Companies (Second Amendment) Act, 2002.

¹³ The concept of materiality – which is fundamental to the entire auditing process – should be borne in mind while reporting on this clause as in the case of other clauses of the Order.

contravention and the fact that the company has not complied with the Order issued by the CLB.

65. 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 five crores rupees 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. [Paragraph 4(vii)]¹⁴

Comments

- (a) This clause has a mandatory application for the listed companies irrespective of the size of paid-up capital and reserves, or turnover. In respect of non-listed companies the clause is applicable only if:
 - (i) the paid-up capital and reserves of the company exceed rupees fifty lakhs; or
 - (ii) an average annual turnover exceeding rupees five crores for a period of three consecutive financial years immediately preceding the financial year concerned.
- (b) Companies which have a paid-up capital and reserves of rupees fifty lakhs or less and the companies which have an average annual turnover of rupees five crores or less for a period of three consecutive financial years immediately preceding the financial year concerned are excluded from the applicability of the clause. 'Financial year concerned' means the financial year under audit.
- (c) It may be noted that the limit of rupees fifty lakhs applies to the total capital and reserves and not to merely the equity capital. Reference should also be made to paragraphs 21 to 23 of this Statement that discuss the considerations for determination of limit of paid-up capital and reserves.
- (d) While in respect of companies which are excluded, there is no necessity to make any specific mention in the audit report, the auditor would still be

¹⁴ This clause has been substantially modified vis-à-vis the corresponding clause under MAOCARO, 1988. The applicability of the clause under MAOCARO, 1988 was based on the quantum of paid-up capital or turnover only.

well-advised to make inquiries regarding internal audit since it forms an integral part of the system of internal control which the auditor normally examines as a part of the audit function.

- (e) The term “turnover” for the purposes of this clause may be interpreted to mean the aggregate amount for which sales are effected or services rendered by an enterprise. If sales tax and excise duty are included in the sale price, no adjustment in respect thereof should be made for considering the quantum of turnover. Trade discount can be deducted from sales but not the commission allowed to third parties. If, however, the excise duty and/or sales tax recovered are credited separately to Excise Duty or Sales Tax Account being separate accounts and payments to the authority are debited in the same account, they would not be included in the turnover. However, sales of scrap shown separately under the heading ‘miscellaneous income’ will have to be included in turnover.
- (f) A company may be covered by this clause on the turnover criterion in one year and may not be so covered in another year. Moreover, since average turnover of three financial years immediately preceding the financial year under audit is to be considered, it would follow that a company cannot be covered by this clause during the first three years of its operation on the basis of the turnover criterion. It may also be noted that the financial year may comprise of more or less than a period of 12 months.
- (g) A company may either have its own internal audit department or entrust the work of internal audit to an outside agency. In the case of a group of concerns, it is also quite common to have a central internal audit department. The arrangement which is more suitable will depend upon the circumstances of each company but generally, where a company is small, it may find it expensive to have its own internal audit department staffed by personnel having the requisite qualifications.
- (h) The auditor has to examine whether the internal audit system is commensurate with the size of the company and the nature of its business. The following are some of the factors to be considered in this regard:
 - (i) What is the size of the internal audit department? In considering the adequacy of internal audit staff, it is necessary to consider the nature of the business, the number of operating points, the extent to which control is decentralised, the effectiveness of other forms of internal

control, etc.

- (ii) What are the qualifications of the persons who undertake the internal audit work? Internal auditing, as its name implies, is an aspect of audit and, therefore, it is reasonable to expect that the internal audit department should normally be headed by a chartered accountant and that depending upon the size of the department, it employs other qualified persons. In deciding the adequacy of the internal audit department, it is, therefore, necessary that there is adequate number of qualified personnel.
- (iii) To whom does the internal auditor report? In general, the higher the level to which the internal auditor reports, the greater will be his independence.
- (iv) What are the areas covered by the internal audit? Internal audit can cover a large number of areas including operational auditing, organisation and methods studies, special investigations and the like. For the purposes of the Order, however, the important areas which should be covered by internal audit are the examination of the operating systems to ensure that the systems are adequate and functioning in practice. The exact areas to be covered by the internal audit would depend upon the circumstances of each case but the statutory auditor should ask the internal auditor to provide the programme of his work and should determine whether, in his opinion, the coverage is adequate. If he feels it is not, he may suggest to the internal auditor to extend the programme in the required direction.
- (v) Has the internal auditor adequate technical assistance? In a number of companies, where the operations are highly technical in nature, an internal auditor cannot function effectively unless he has adequate technical assistance. This can be provided either by having full-time technically qualified persons in the internal audit department or by such persons being deputed to the internal audit department for specific assignments. Similar considerations would apply where a large part of the transactions are computerised. In such cases, the internal auditor should have the assistance of persons who are able to audit computer systems.
- (vi) What are the reports which are submitted by the internal auditor or

what other evidence is there of his work? It is important that the auditor should satisfy himself that not merely does an internal audit system exist but also that it is functioning effectively. He can do so by examining the reports submitted by the internal auditor.

- (vii) What is the follow-up? It is not sufficient that the internal audit system should point out errors in operation or deficiencies in the internal control system. It is equally necessary that there is an adequate follow-up system to ensure that the errors pointed out are corrected and remedial action taken on the deficiencies reported upon.
- (i) It is important to note that 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. Moreover, since this part of the Order refers only to companies having a paid-up capital and reserves in excess of Rs. 50 lakhs or an average annual turnover in excess of Rs. 5 crores for a period of three consecutive financial years immediately preceding the financial year concerned, it is desirable that such a company has an internal audit system.
- (j) It is equally important to note that the internal audit system is a part of the overall internal control system. Therefore, the scope of the internal audit and the extent of its coverage will, to some extent, depend upon the existence or otherwise of other forms of internal control. This is also a factor to be considered when evaluating the adequacy of the internal audit system.

66. *Where maintenance of cost records has been prescribed by the Central Government under Section 209 (1) (d) of the Companies Act, 1956 (1 of 1956), whether such accounts and records have been made and maintained.* [Paragraph 4(vii)]

Comments

- (a) Section 209 (1) (d) requires a company pertaining to a class of companies engaged in production, processing, manufacturing or mining activities to maintain proper books of account showing particulars relating to utilization of material or labour or to other items of cost as may be

prescribed, if the Central Government requires such class of companies to maintain such records. Pursuant to this requirement and in exercise of the powers conferred by sub-section (1) of Section 642, the Central Government has made rules in respect of a large number of classes of companies. These books of account and records form part of the books of account of the company within the meaning of Section 209. A list of classes of companies in respect of which maintenance of cost records under section 209(1)(d) has been prescribed up to January 31, 2004, is given in Appendix V.

- (b) The Cost Accounting Records Rules issued for various industries contain requirements relating to two matters:
 - (i) maintenance of proper books of account relating to materials, labour, and other items of cost; and
 - (ii) preparation of cost statements at the end of the financial year in accordance with the rules specific to the industry concerned.

While the records relating to materials, labour, etc. are required to be maintained on a day-to-day basis, the cost statements have to be prepared periodically.

- (c) Section 233-B provides that where, in the opinion of the Central Government, it is necessary so to do in relation to any company required by Section 209(1)(d) to maintain the particulars prescribed under that section, it may order an audit to be conducted of its cost accounts.
- (d) It will be noticed that while a cost audit can be done only in respect of companies governed by the Rules made under Section 209(1)(d), cost audit is not necessary in respect of every company which is required to maintain cost records.
- (e) The Order requires the auditor to report whether cost accounts and records have been made and maintained. The word “made” applies in respect of cost accounts (or cost statements) and the word “maintained” applies in respect of cost records relating to materials, labour, overheads, etc. The auditor has to report under the clause irrespective of whether a cost audit has been ordered by the Central Government. The auditor should obtain a written representation from the management stating (a) whether cost

records are required to be maintained for any product(s) of the company under Section 209(1)(d), and (b) whether cost accounts and records are being made and maintained regularly. The auditor should also obtain a list of books/records made and maintained in this regard. The Order does not require a detailed examination of such records. The auditor should, therefore, conduct a general review of the cost records to ensure that the records as prescribed are made and maintained. He should, of course, make such reference to the records as is necessary for the purposes of his audit.

- (f) It is necessary that the extent of the examination made by the auditor is clearly brought out in his report. The following wording is, therefore, suggested:

“We have broadly reviewed the books of account maintained by the company pursuant to the Rules made by the Central Government for the maintenance of cost records under Section 209(1)(d) of the Companies Act, 1956 and are of the opinion that *prima facie*, the prescribed accounts and records have been made and maintained.”

Where the auditor finds that the records have not been written up or are not *prima facie* complete, it will be necessary for the auditor to make a suitable comment in his report.

67. 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 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.[Paragraph 4(ix)(a)]

Comments

- (a) The following are the points of difference between this clause and the corresponding requirements of the erstwhile MAOCARO, 1988:
- (i) This clause requires the auditor to comments upon the regularity of the company in depositing, among other things, undisputed dues of provident fund and employees state insurance. These dues were

subjected to a separate clause under MAOCARO, 1988.

- (ii) The corresponding clause under MAOCARO, 1988 did not require the auditor to state over-due amounts as required by this clause.
 - (iii) Further certain new statutory obligations such as contributions to investor education and protection fund and cess has been included in the list of statutory payments. The old clause restricted its application to the listed statutory payments, whereas the new clause requires comments in respect of undisputed statutory dues including the listed nature of payments and “any other” statutory dues.
- (b) It may be noted that the words “statutory dues including provident fund, investor education and protection fund, employees state insurance, income-tax, sales-tax, wealth tax, custom duty, excise duty, cess” indicates that the clause would cover all types of dues under the respective Acts. Apart from the statutory dues listed, the auditor would also be required to report on any other statutory dues payable by the company. In cases of irregularities, the auditor has to report the extent of arrears.
- (c) It may be noted that the auditor has to report on the regularity of deposit of statutory dues irrespective of the fact whether or not there are any arrears on the balance sheet date. This is because there may be situations where a company has deposited the relevant dues before the end of the year while it has been in default in the matter for a significant part of the year. In cases where there are no arrears on the balance sheet date but the company has been irregular during the year in depositing the statutory dues, the extent of arrears during the year should also be stated.
- (d) While the auditor has to report upon the regularity of the deposit, he is not required to specify in detail each instance where there has been a delay or the extent of the delay. It should be sufficient if he indicates whether generally the deposits have been regular or otherwise. The following are examples of the wording which may be used:

“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 have been regularly deposited by the company with the appropriate authorities in all cases during the

year”.

“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 have generally been regularly deposited with the appropriate authorities though there has been a slight delay in a few cases”.

“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 have not generally been regularly deposited with the appropriate authorities though the delays in deposit have not been serious”.

“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 have not been regularly deposited with the appropriate authorities and there have been serious delays in a large number of cases”.

- (e) For the purpose of this clause, the auditor should consider a matter as “disputed” where there is a positive evidence or action on the part of the company to show that it has not accepted the demand for payment of tax or duty, e.g., where it has gone into appeal. For this purpose, where an application for rectification of mistake (e.g., under Section 154 of the Income tax Act, 1961) has been made by the company, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of a statutory due is for a certain amount and the dispute relates only to a part and not the whole of such amount, only such amount should be treated as disputed and the balance amount should be regarded as undisputed. It is not necessary for the auditor to examine the sustainability or otherwise of the claim of the company regarding disputed amounts. It is sufficient for his purpose if the evidence available shows that the amount is disputed by the company. It may also be noted that the Order has clarified that mere representation to the concerned Department does not constitute the dispute.
- (f) Another question that arises is that when does the statutory dues become payable. There can be two views with regard to the question. On the one hand, it can be argued that the statutory dues referred to in this clause

become payable on the last date by which payment can be made without attracting penalty and/or interest under the relevant law. On the other hand, it can also be argued that the amounts referred to in the clause become so payable as at the date of the expiry of the stay granted by the authorities or, where instalments have been granted for the payment a statutory dues referred to in the clause, the date on which the default occurs and the amount becomes payable to the authorities. As the purpose of this clause is to indicate the amounts which have become actually payable and are outstanding as at the last day of the financial year concerned for a period of more than six months from the date they became payable, the latter view seems to conform more closely to the requirements of the Order.

- (g) It may be noted that penalty and/or interest levied under the respective laws would be covered within the term “amounts payable”.
- (h) Where there are arrears of statutory dues, it is not sufficient to merely report that there are arrears. It is also necessary to indicate the extent of the arrears. In indicating the arrears, the period to which the arrears relate should preferably also be given and further, wherever possible, the fact of subsequent clearance or otherwise may also be indicated.
- (i) The report should be restricted to the actual arrears and should not include the amounts which have not fallen due for deposit and have been shown as arrears at the balance sheet date.
- (j) It is possible that in a large company where there are a number of departments with separate payrolls and where payments are spread over a number of days, the collection of data regarding the provident fund/employees’ state insurance collections and the company’s contribution thereto may take some time. In order to ensure that deposit of the dues is made in time, the company may make lump-sum deposits of estimated amounts and adjust the excess or deficit against the following month’s deposit. If this method is consistently followed and the difference between the total dues and the lump-sum deposit is not significant, it need not be considered that dues have not been regularly deposited and no adverse comment is necessary¹⁵.

¹⁵ This concept of materiality – which is fundamental to the entire auditing process – should be borne in mind while reporting on this clause as in the case of other clauses of the Order.

- (k) The auditor should make plans to test whether the company is regular in depositing undisputed statutory dues. The auditor, in order to be able to comment on this clause, should obtain a general understanding of the various statutes governing the entities and the dues payable by the company under those statutes. The auditor should also enquire of the management of the company about the statutes under which the company is required to pay any statutory dues. The auditor should also discuss with the management the policies or procedures adopted for identifying and payment of statutory dues.
- (l) The information necessary to comply with this requirement of the Order may be obtained from the company in the form of a statement. The statement should contain a list of various statutes under which the company is required to make payments to appropriate authorities, the kind of payments under each statute, the due date for making the payment to the appropriate authority, the date on which the payment is made by the company, the arrears not due and the arrears over due for more than six months. The auditor should verify the statement provided by the management with the underlying documents and records. The auditor's general understanding of the various statutes governing the entities and the dues payable by the company under those statutes would help the auditor in assessing the completeness of the statement. The auditor should recognise that there could be a situation that a statutory due might have become payable but not have been captured by the accounting and internal control systems established by the enterprise and, therefore, the auditor should perform procedures to mitigate risk arising from the situation.
- (m) If the auditor is of the opinion that the company is not 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 and any other statutory dues with the appropriate authorities, 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, are required to be mentioned by the auditor in his audit report. The following is the format in which the auditor can report the extent of the arrears of outstanding statutory dues:

<i>Name of the Statute</i>	<i>Nature of the Dues</i>	<i>Amount (Rs.)</i>	<i>Due Date</i>	<i>Date of Payment</i>
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- (n) The auditor should obtain a written representation with reference to the date of the balance sheet from the management -
- (i) specifying the cases and the amounts considered disputed;
 - (ii) containing a list of the cases and the amounts in respect of the statutory dues which are undisputed and have remained outstanding for a period of more than six months from the date they became payable;
 - (iii) containing a statement as to the completeness of the information provided by the management.

68. *In case dues of sales tax/income tax/custom tax (duty)/wealth tax/excise duty/cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending may please be mentioned. [Paragraph 4(ix)(b)]*

Comments

- (a) The clause requires that in case of disputed statutory dues, the amounts involved should be stated along with the forum where the dispute is pending. The audit procedures mentioned at paragraph 85 above would help the auditor in determining the dues of sales tax/income tax/custom tax (duty)/wealth tax/excise duty/cess that have not been deposited on account of any dispute, the amounts involved and the forum where dispute is pending. The information required by the clause may be reported in the following format:

<i>Name of the Statute</i>	<i>Nature of the Dues</i>	<i>Amount (Rs.)</i>	<i>Forum where dispute is pending</i>
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- (b) It is possible that in respect of same nature of statutory dues, there may be more than one dispute in respect of different periods for which, appeals may have been filed separately. For example different years' income tax liabilities may have been disputed at different levels of appellate

authorities. Hence in such cases, the information required by the clause should be given separately in respect of each period.

- (c) It is clarified here that mere representation to the concerned Department does not constitute dispute.

69. 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 per cent 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. [Paragraph 4(x)]

Comments

- (a) The clause is applicable to companies that are in existence for more than five years from the date of registration till the last day of the financial year covered by the auditor's report. The clause requires the auditor to report:
- whether the accumulated losses at the end of the financial year are more than 50% of its net worth; and
 - whether the company has incurred cash losses during the period covered by the report and in the financial year immediately preceding the period covered by the report.
- (b) The auditor should compute the accumulated losses and the net worth to verify whether the accumulated losses at the end of the financial year are more than 50% of the company's net worth.
- (c) A question arises about the exact connotation of the term "loss" for ascertaining the amount of accumulated losses. More specifically, the issue is whether, for the purpose of reporting by the auditor, the net loss shown by the profit and loss account should be taken as the loss or whether any adjustments need to be made in the figure of net profit/loss. The term "loss" should be construed to mean the net profit/loss shown by the profit and loss account of the company as adjusted after taking into account qualifications in the audit report to the extent the qualifications are quantified.
- (d) Section 2(29A) of the Act defines the term "net worth" as "sum total of

the paid-up capital and free reserves after deducting the provisions or expenses as may be prescribed”. The explanation to the definition further provides that for the purpose of this definition, “free reserves” means all reserves created out of profits and share premium account but does not include reserves created out of revaluation of assets, write back of depreciation provisions and amalgamation. The figure of net worth computed from the balance sheet of the company should also be adjusted for the effect of qualifications in the audit report to the extent the qualifications are quantified.

- (e) The auditor is also required to report whether the company has incurred cash losses during the period covered by the report and in the financial year immediately preceding the period covered by the report. In order to determine the figure of cash loss for the financial year, the loss shown by the profit and loss account is adjusted for the effects of transactions of a non-cash nature, any deferrals or accruals of past or future cash receipts or payments. These adjustments would include:
 - (i) changes during the period in inventories and operating receivables and payables;
 - (ii) non-cash items such as depreciation, provisions, deferred taxes, and unrealised foreign exchange gains and losses; and
 - (iii) changes during the period in cash and cash equivalents.
- (f) The figure of cash loss of the company for the financial year covered by the audit report and the immediately preceding financial year should also be adjusted for the effect of qualifications in the respective audit reports to the extent the qualifications are quantified. The figures of cash losses should be mentioned while reporting on this clause.
- (g) The auditor while reporting on this clause should indicate that his opinion on the matters stated in the clause has been arrived at after considering the effect of the qualifications on the figures of accumulated losses, net worth and cash losses. Where any of the qualifications in the audit report is not capable of being quantified, the auditor should state that the effect of such unquantified qualification(s) has not been taken into consideration for the purpose of determining:

- (i) whether the accumulated losses at the end of the financial year are more than 50% of the company's net worth; and
- (ii) whether the company has incurred cash losses in the financial year and in the financial year immediately preceding such financial year also.

70. *Whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported.* [Paragraph 4 (xi)]

Comments

- (a) Under this clause, the auditor is required to report whether the company has defaulted in repayment of dues to a financial institution or bank or to debenture holders. If the answer is in the affirmative, the auditor is also required to mention the period of default and the amount of default.
- (b) Dues to financial institutions, banks or debenture holders would include the following:
 - (i) Term Loan repayments.
 - (ii) Term Loan interest.
 - (iii) Interest on Working capital limits by whatever name called.
 - (iv) Balance of term loans if the lenders recall loans, for example, due to violation of sanction terms.
 - (v) Balance of working capital limits if such facilities are recalled by bankers/lenders, for example, due to violation of sanction terms.
 - (vi) Debenture redemption (principal as well as interest) amounts.
 - (vii) Term loan repayments/interest payment dues to foreign Banks, ECB, or similar Institutions, whether the lenders are situated in India or not.
- (c) The auditor should obtain a schedule of repayments to banks, financial institutions and debenture holders from the management of the company. The schedule should indicate the amount and timing of the payments that

the company is required to make to banks, financial institutions and debenture holders.

- (d) The auditor should examine the agreement, terms and conditions of the loans and borrowings of the company from banks and financial institutions. The auditor should also examine the debenture trust deed. This examination enables the auditor in verifying the amount and timing of the payments mentioned in schedule of repayments provided by the management of the company. The auditor should then verify whether the repayments as per the books of accounts are in accordance with the sanction terms. The auditor should satisfy himself that the payment has actually been made to the party concerned.
- (e) Though the word “default” has not been defined, in this regard the word “default” would mean non-payment of dues to banks, financial institutions or debenture holders as the last date for the payment passes. For example, in the case of term loans fixed dates as prescribed for repayment in the agreement, terms and conditions of the loan. The dates prescribed for repayments would operate, as the last date of payments and any delay after this fixed date would amount to default. In case of interest dues, normally a month’s time is provided from the date of debit. Any delay beyond the said month would amount to default.
- (f) It may happen that the company might have submitted application for reschedulement/restructuring proposals to the lenders, which may be in different stages of processing. In such a situation also the auditor should report the period of default and the amounts of default. Submission of application for reschedulement/restructuring does not mean that no default has occurred.
- (g) The auditor may come across a situation where there may be disputes between the company and the lender on various issues. In all such situations, the auditor should give a disclaimer that since there is a dispute between the company and the lender; he is unable to determine whether there is a default in repayment of dues to the lender concerned.
- (h) Apart from reporting the period of default and amounts involved separately for each loan, the auditor should also provide a description of the loan and the lender’s name.

71. *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.* [Paragraph 4 (xii)]¹⁶

Comments

- (a) The clause requires the auditors to comment on the adequacy of documents and records 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 the auditor is not satisfied about the adequacy of documents and records he has to report the same under this clause.
- (b) This requirement is confined to loans and advances which are secured by way of pledge and does not extend to other forms of security, e.g., hypothecation, guarantee, etc.
- (c) Pledge implies that the physical possession of the security must be transferred to the company. This transfer can be actual or constructive. For example, the share or debenture may be physically in the custody of the company or it may be with a person like a bank which holds it on behalf of the company.
- (d) A question may arise as to the exact meaning of the term “other securities”. The term, ‘other securities’ may be construed to mean bonds or promissory notes issued by a government or semi-government authority. In a broader sense, it can include any other asset which is given as security for repayment of a loan or fulfillment of an obligation. However, 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.
- (e) The auditor has to report whether adequate documents and records have been maintained. What records would be considered adequate depends upon the nature of the security and the party to whom the loan or advance is granted. But the records should generally include the following

¹⁶ Under MAOCARO, 1988 the auditor was required to report on this clause only in the case of a finance, investment, chit fund, nidhi or mutual benefit company.

particulars:

- (i) The full name and address of the borrower.
 - (ii) The amount of the loan or advance.
 - (iii) Stipulations regarding period of repayment, the rate of interest, the security to be pledged and all other terms of the loan or advance.
 - (iv) The record of the disbursements, repayments towards the loan or advance and recovery of the interest.
 - (v) Full particulars of the security pledged. For example, if the security consists of shares, the particulars would include the names of the companies, number of shares, class of shares, distinctive numbers of the shares, particulars of the parties in whose names the shares stand, etc.
 - (vi) The documents needed to transfer the ownership of the security in case of need.
 - (vii) Periodical acknowledgements from the parties confirming the balances due.
 - (viii) Proof that the party has power to borrow, e.g., in case the borrower is a company, its memorandum of association, board resolution or shareholders' resolution.
 - (ix) Information about market value of securities such as stock exchange quotations.
- (f) There is no requirement to report as to whether the security is being properly maintained. This may be due to the fact that an inquiry in this regard has to be made by the auditor in terms of Section 227 (1A). In any event, it remains the duty of the auditor to ensure by physical verification that, where a loan or advance is given on the basis of a pledge of shares, debentures or other securities, the securities are in the custody of the company and that the market value of the securities is adequate to cover the outstanding amount of the loan and interest. The auditor should also physically verify the securities pledged by reference to either the physical securities or statements from depository participants.

- (g) The auditor, apart from reviewing and examining regular books of account, has to examine various documents and records as referred above and list out the deficiencies, if any. The deficiencies could be absence of noting of lien, insufficient margins, registers not being updated, absence of data relating to market value of securities etc. The auditor should also report the deficiencies so found.

72. *Whether the provisions of any special statute applicable to chit fund have been duly complied with?* [Paragraph 4(xiii) First Part]

Comments

- (a) The clause is required to be commented upon by the auditor only in case of chit fund company. Therefore, the auditor should determine whether the company is carrying on the chit fund business. It may be noted that the Order contains a single definition of the terms “chit fund company”, “*nidhi* company” or “mutual benefit company”. According to the Order “chit fund company”, “*nidhi* company” or “mutual benefit company” means a company engaged in the business of managing, conducting or supervising as a foreman or agent of any transaction or arrangement by which it enters into an agreement with a number of subscribers that every one of them shall subscribe to a certain sum of instalments for a definite period and that each subscriber, in his turn, as determined by lot or by auction or by tender or in such other manner as may be provided for in the agreement, shall be entitled to a prize amount, and includes companies whose principal business is accepting fixed deposits from, and lending money to, members.”
- (b) A chit fund company is a company that carries on the business of chit funds within the meaning of the Chit Funds Act, 1982. Clause (b) of section 2 of the Chit Funds Act, 1982 defines the “chit” as a transaction whether called chit, chit fund, chitty *kuri* or by any other name by or under which a person enters into an agreement with a specified number of persons that every one of them shall subscribe a certain sum of money (or a certain quantity of grain instead) by way of periodical instalments over a definite period and that each such subscriber shall, in his turn, as determined by lot or by auction or by tender or in such other manner as may be specified in the chit agreement, be entitled to the prize amount. Explanation to the definition provides that a transaction is not a chit within the meaning of this clause, if in such transaction:

- (i) some alone, but not all, of the subscribers get the prize amount without any liability to pay future subscriptions; or
 - (ii) all the subscribers get the chit amount by turn with a liability to pay future subscriptions.
- (c) Further, it may be noted that unlike a chit fund company, which because of its being in the business of conducting chits is classified as a chit fund company, “*nidhis*” or “mutual benefit societies” are the companies which are notified by the Central Government to be a “*nidhi*” or a “mutual benefit society” under section 620A of the Act. It may also be noted that a company which is declared as a “*nidhi*” or a “mutual benefit society” by the Central Government under section 620A cannot carry on the business of chit fund, hire purchase finance, leasing finance, insurance or acquisition of shares or debenture issued by any body corporate except the shares of another “*nidhi*”, if specifically permitted by the Central Government.
- (d) This is a very wide requirement and taken literally would mean that the auditor has to ensure that the company complies with all the requirements of the relevant special statutes. Obviously, this cannot be the intention. A more rational interpretation would, therefore, be that the auditor has to satisfy himself and report that the company has complied with all the provisions of the special statutes in so far as they have application to the accounts of the chit fund company. It is necessary that the audit report should clearly state the above interpretation. The following is an example of the report:
- “To the best of our knowledge, the company has complied with the provisions of in so far as the provisions are applicable to the accounts under report.”
- (d) It may also be noted that special statutes applicable to chit fund companies, vary from State to State. This is because of the fact that the Central Government enacted the Chit Funds Act, 1982 (Act No. 40 of 1982) which extends to the whole of India except the State of Jammu and Kashmir. According to section 1(3) of the Act, it comes into force on such date as the Central Government may, by notification in the official gazette, appoint and different dates may be appointed for different States. So far, the Central Government has notified the date of the Act coming

into force in respect of certain States and Union Territories only.¹⁷ In respect of States and Union Territories for which no date for the Chit Funds Act, 1982 coming into force, the respective states/union territories have either enacted relevant Act and rules in this regard or have adopted the Chit Funds Act, 1982 as it is. The auditor should study and gain an understanding of the relevant Acts and the rules which are applicable to the company situated in a particular State/Union Territory. It may also happen that the company's branches may be situated in more than one State, in which case, the provisions of different States' Acts and rules will be applicable to the respective branches/offices. In such situations, it is advisable for the auditor to seek legal opinion regarding the applicability and compliance with the relevant provisions of the Acts/rules.

73. In respect of nidhi/mutual benefit fund/societies:

(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 schedule 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. [Paragraph 4(xiii) Second Part; Sub-clauses (a) to (d)]

Comments

(a) The sub-clause (a) requires the auditor to report whether, in the case of a *nidhi* and mutual benefit society, net-owned funds to deposit liability ratio is more than 1:20 as on the date of balance sheet. It may be noted that according to the directions issued by the Central Government *vide* notification number GSR 555(E) dated 26th July 2001 a "*nidhi*" or a

¹⁷ The States and Union Territories for which the dates have been notified by the Central Government are Karnataka, West Bengal, Tamil Nadu, Chandigarh, Dadra and Nagar Haveli, Lakshadweep, Himachal Pradesh, Sikkim, Andaman and Nicobar Islands, Orissa, Goa, Daman and Diu, Madhya Pradesh, Madhya Pradesh, Pondichery, Meghalaya, Uttar Pradesh, Rajasthan, Bihar and Punjab.

“mutual benefit society” may accept deposits not exceeding twenty times of its net owned funds as per last audited balance sheet.¹⁸

- (b) According to the directions notified by the Central Government, the term “net owned funds” in the case of a *nidhi* or a mutual benefit society means the aggregate of paid-up equity capital and free reserves as reduced by accumulated losses and intangible assets appearing in the last audited balance sheet of the company. As far as “free reserves” are concerned, a reserve is considered as a “free reserve” if it is available for distribution as dividend. Further, the amount representing the proceeds of issue of preference shares shall not be included for calculating net-owned funds. However, for *nidhis* or mutual benefit societies existing on or before 26th July 2001, the proceeds of issue of preference shares are to be included for calculation of net-owned funds up to the financial year 31st March 2003.
- (c) A *nidhi* or a mutual benefit society can open fixed deposit accounts, recurring deposit accounts and savings deposits account in accordance with the directions notified by the Central Government. The term “deposit liability” would mean the aggregate of deposits accepted by the company.
- (d) The auditor should compute the ratio using the figures of net owned funds and deposit liability computed in accordance with what is stated above. It may be noted that the reference to the last audited balance sheet should be construed to mean the balance sheet for the current on which the auditor is issuing the report.
- (e) The sub-clause (b) requires the auditor to state whether, the company has complied with the prudential norms on income recognition and provisioning against sub-standard/doubtful and loss assets. The requirement is similar to the one that exists in the case of banks. This requirement is in addition to the audit procedures that the auditor normally performs in respect of advances for obtaining evidence about their existence, completeness, valuation and disclosure.
- (f) *Nidhis* and mutual benefit societies can give loans to its shareholders or members against the security of gold, silver, jewellery, immovable

¹⁸ The directions issued by the Government of India are subject to changes from time to time.

property, fixed deposit, kisan vikas patra, national savings certificates, insurance policies and other Government securities. The Central Government, *vide* notification number GSR 309 E dated 30th April 2002 issued prudential norms for revenue recognition and classification of assets in respect of mortgage or jewel loans. The text of the Circular is reproduced in Appendix VI.¹⁹

- (g) The auditor should examine whether the prudential norms for revenue recognition and classification of assets has been complied with by the *nidhi* or mutual benefit society in the preparation and presentation of the financial statements. However, these norms should be construed as laying down the minimum provisioning requirements and wherever a higher provision is warranted in the context of the threats to recovery, such higher provision should be made. Where the *nidhi* or the mutual benefit society has not complied with the prudential norms the auditor should state the fact while reporting on the clause. Further, the non-compliance of such norms would also require a qualification to this effect in the auditor's report on financial statements.
- (h) The sub-clause (c) requires the auditor to examine, study and analyse the various procedures prevailing in the company for appraisal of credit proposals/requests, assessment of credit needs and repayment capacity of the borrowers. The auditor should study the policies and procedures regarding appraisal of credit proposals/requests, assessment of credit needs and repayment capacity of the borrowers. It may so happen that a company might have a separate set of policies and procedures for appraisal of credit proposals/requests of employees. The auditor should also study the same. Such guidelines should normally include steps to be followed for detailed verification of the proposal to assess need of credit and the repayment capacity of the borrower. For credit needs above certain levels, the companies normally insist on security. The auditor has to verify whether the policies and procedures established by the company in this regard have been followed in sanctioning, disbursements and post-sanction follow-up and follow-up for repayment of loans. Study of the individual borrower files would indicate whether proper systems and procedures have been followed. Based on his assessment, the auditor has to form an opinion about the adequacy of procedures in the credit

¹⁹ The directions issued by the Government of India are subject to changes from time to time.

department and accordingly comment on this clause. The auditor can gather the requisite evidence by examining relevant documents (such as loan application forms, supporting documentation, sanctions, security documents, etc.) and by obtaining information and explanations from the management in appropriate cases.

- (i) The sub-clause (d) requires the auditor to comment on whether the repayment schedule 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. Where the number of loans granted by the company is very large, it is obviously not feasible for the auditor to satisfy himself that every single loan's repayment schedule granted by the *nidhi* is based on the repayment capacity of the borrower and would be conducive to recovery of the loan amount deposit complies with the rules. He should, therefore, examine the system by which loans are granted make a reasonable test check to ensure that the system operates. He may also make a "check list" to ensure that all the requirements of the Rules regarding the records to be maintained, returns to be filed, etc., are complied with.
- (j) The auditor should list a certain number of cases to find out the facts and verify the same against the actual repayments made by the respective borrowers. This verification is possible only in cases where the repayments are due. In cases where the repayments are not yet due, the study has to be limited only to assess about the amount fixed towards repayment based on the assessed repayment capacity of the borrower.
- (k) In cases, where the auditor is not convinced about the repayment schedule drawn by the company based on the repayment capacity of the borrower, the same is to be reported under this clause. The intensity of the comment would depend on the seriousness of the lapses and the materiality of the amounts, and number of cases.

74. 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 except to the extent of the exemption, if any, granted under section 49 of the Act. [Paragraph 4(xiv)]

Comments

- (a) This requirement can be considered in three parts, namely:
 - (i) whether records regarding transactions and contracts are maintained;
 - (ii) whether timely entries have been made in such records; and
 - (iii) whether the investments are in the company's own name.
- (b) The requirement applies to companies which deal or trade in shares, securities debentures and other investments. To deal or trade implies a purchase or sale with a view to make profit. Therefore, this requirement does not apply to companies which are not dealing or trading in investments but which purchase investments with a view to hold such investments and earn income from dividend or interest thereon. It is sometimes difficult to determine whether the company is dealing or trading in investments or whether it is merely holding investments. Some of the factors which may be considered in this connection are as follows:
 - (i) The objects of the company as stated in the Memorandum of Association.
 - (ii) The period of time for which individual investments are held before they are sold.
 - (iii) The reasons, to the extent they can be determined, for purchase or sale of an investment.
 - (iv) Internal procedure, orders or directives regarding purchase and sale of investments.
 - (v) Method of valuation of investments for balance sheet purposes. For example, if investments are valued at cost, the indication would be that the company is not an investment company. If, however, investments are valued at lower of cost and market value, or if investments are valued at market value, the indication would be that the company is dealing or trading in investments.
 - (vi) The status given to the company in its tax assessments, that is, whether it is treated as a dealer in investments (profits being subjected to tax as business profits) or whether it is treated as an

investor (profits being subjected to tax as capital gains).

- (c) In deciding whether records have been properly maintained, the auditor has to examine both, whether the form in which records are maintained is adequate and also whether the records themselves are properly written up and preserved. The adequacy of the records has to be tested in the light of their ability to give details of (i) purchases and sales and the profit or loss arising on sale, (ii) the stock of investments and their valuation, and (iii) the amounts due for sales and payable for purchases. Some of the features to be examined in this connection would be the following:
 - (i) Details regarding the purchase and sale, that is, the particulars about the person from whom or to whom the purchase or sale was made, the rate at which the purchase or sale was made, the number of shares or other investments with full details regarding class, distinctive numbers, numbers of certificates, etc., and the document, for example, bought note or sale note evidencing the sale.
 - (ii) The adjustment, if any, necessary when securities are purchased or sold and whether the quotations are exclusive of interest accrued or, when shares are purchased or sold ex-dividend whether dividend has to be paid or received.
 - (iii) The details of holdings in individual companies, the classes of investments (e.g., equity shares, preference shares, debentures, etc.), the basis on which the closing stock is valued and the profit or loss on sale is to be computed.
 - (iv) The recording of shares received as bonus shares; the accounting of rights subscribed for or sold.
 - (v) The individual accounts of the parties from whom moneys are due for sale or to whom moneys are payable for purchases and the settlements made there against.
- (d) The auditor is also required to examine whether timely entries are made in the records. This may be done by one or more of the following methods:
 - (i) a surprise inspection of the records;
 - (ii) an examination of the system of internal control with particular

reference to the manner in which and the time at which entries are made in the records; and

- (iii) an examination of the internal audit reports to ensure if the programme of internal audit specifically covers an inspection of the records to determine whether entries are made in time.
- (e) Section 49 of the Act requires that all investments have to be made and held in the company's own name. The exemptions provided by the section are:
- (i) where a person is appointed as a nominee of the company on the board of directors of another company and such nominee is required to hold qualification shares, then to the extent of such qualification shares;
 - (ii) where a company has a subsidiary and it is necessary to ensure that the number of members of the subsidiary is not reduced below seven in the case of a public company and two in the case of a private company;
 - (iii) in the case of a company whose principal business consists of the buying and selling of shares or securities;
 - (iv) in the case of investments deposited with a bank for collection of dividend or interest or for transfer into such bank's name to facilitate transfer; and
 - (v) in the case of investments pledged as security for loans or for performance of obligations.
- (f) The auditor is required to report whether the investments are held in the company's own name in respect of companies which deal or trade in investments. However, Section 49(4) specifically exempts companies whose principal business is the buying and selling of shares or securities from that requirement. It seems, therefore, that the requirement to report will arise when the buying and selling of shares or securities is not the principal business of the company but it does such business along with some other business.
- (g) When a company deals or trades in investments it is possible that

investments which are intended or contracted to be sold immediately may not have been transferred to the company's own name. The auditor should, therefore, use his discretion to ascertain whether, in the circumstances of each case, the failure to transfer the investments to the company's name is understandable.

75. 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. [Paragraph 4 (xv)]

Comments

- (a) Guarantee given by a company is a contingent liability. In respect of contingent liabilities, the auditor is normally concerned with seeking reasonable assurance that all contingent liabilities are identified and properly valued. The clause, however, requires the auditor to examine the terms and conditions of guarantees given by the company for loans taken by other and report whether the terms and conditions of the guarantees are prejudicial to the interests of the company.
- (b) The auditor should obtain a listing of the guarantees issued by the company from the management of the company. The auditor should verify that the management has disclosed all the guarantees given by the company. The auditor should perform substantive audit tests to establish the completeness of the guarantees recorded. Such tests include confirmation procedures as well as examination of relevant records in appropriate cases. The auditor should also ascertain whether there are adequate internal controls over issuance of guarantees, e.g., whether guarantees are issued under proper sanctions, whether adherence to limits sanctioned for guarantees is ensured. Absence of internal controls over issuance of guarantees may be prejudicial to the interests of the company.
- (c) The auditor should review the terms and conditions of the guarantee to establish the reasonableness thereof in the light of previous experience and knowledge of the current year's activities. In determining whether the terms of the loans are "*prima facie*" prejudicial, the auditor would have to give due consideration to a number of factors connected with the guarantee, including the financial standing of the party for which the company has given the guarantee, its ability to borrow, the nature of the security offered by the party, tangible/intangible benefits accruing to the

company, the availability of alternative sources of finance, the urgency of the borrowing for which the company has given guarantee and so on. The auditor may well come to the conclusion that better terms could have been placed for making the guarantee but unless the difference in the terms which have been placed and the terms which could have been placed is so significant that no reasonable person would have agreed to provide guarantee on the terms on which the guarantee has been given, it would be difficult for the auditor to conclude that the terms and conditions of the guarantee are prejudicial.

- (d) If the auditor finds that that the company could have provided the guarantee on better terms and conditions, he should obtain the company's explanation in writing as to why the company considers that the terms obtained are not prejudicial to the interest of the company. If the auditor does not find the explanation convincing, it will be necessary for him to state that the terms and conditions on which the company has given the guarantees are prejudicial to the interests of the company. The auditor, in such a case should also disclose the amount involved in such guarantee.
- (e) The auditor should obtain a written representation from the management that:
 - (i) all obligations in respect of guarantees have been duly recorded and disclosed;
 - (ii) there are no guarantees issued up to the year-end which are yet to be recorded; and
 - (iii) the disclosed contingent liabilities do not include any contingencies which are likely to result in a loss and which, therefore, require adjustment of assets or liabilities.

76. *Whether the term loans were applied for the purpose for which the loans were obtained.* [Paragraph 4 (xvi)]

Comments

- (a) The auditor should examine whether the company has taken any "term loans". Loans with repayment periods beyond 36 months are usually called "term loans". Terms loans are generally provided by banks and

financial institutions for acquisitions of capital assets which then become the security for the loan i.e., end use of funds is fixed. Certain term loans are also granted by banks and financial institutions against the existing securities that are readily realisable e.g., term deposits, gold and shares. The terms loans have pre-determined repayment schedule; the disbursal is by way of a limited number of debits and cheque books are not issued.

- (b) The auditor should examine the terms and conditions subject to which the company has obtained the term loans. As mentioned above, normally, the end use of the funds raised by term loans is mentioned in the sanction letter or documents containing the terms and conditions of the loan. The auditor should ascertain the purpose for which term loans were sanctioned. The auditor should also compare the purpose for which term loans were sanctioned with the actual utilisation of the loans. The auditor should obtain sufficient appropriate audit evidence regarding the utilisation of the amounts raised. If the auditor finds that the funds have not been utilized for the purpose for which they were obtained, the auditor's report should state the fact.
- (c) The companies, generally, when during a construction phase temporarily invest the surplus funds to reduce the cost of capital. However, subsequently the same are utilised for the stated objectives. In such cases, the auditor should mention the fact that the funds were temporarily used for the purpose other than for which the loan was sanctioned but were ultimately utilised for the stated end-use.
- (d) It may happen that the company might have acquired improved version/model of assets as against the items which the loan had been sanctioned. As long as the amounts are in agreement with the sanction terms, the same may be accepted subject to the approval of the lenders. Normally the term lenders directly make the payment to the vendors/suppliers of services. In such cases, the query becomes irrelevant and the auditor can report the fact accordingly.

77. Whether the funds raised on short-term basis have been used for long-term investment and vice versa. If yes, the nature and amount is to be indicated. [Paragraph 4 (xvii)]

Comments

- (a) The principles of financial management suggest that the long-term assets of an enterprise should be financed from long-term funds and short-term requirements of funds should be met through short-term sources. The genesis of the principle is that if short-term sources are used for long-term investments, the enterprise faces liquidity problems as soon as the short-term sources fall due for payment except in the situation the enterprise is able to generate sufficient funds through its operations to meet the working capital requirements arising from the event of short-term sources falling due for payment. The application of the principle is considered to be of utmost importance for the financial health of an enterprise. It may also be noted that Auditing and Assurance Standard (AAS) 16, “Going Concern” recognises that fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment, or excessive reliance on short-term borrowings to finance long-term assets is an indication of risk that the going concern assumption may no longer be appropriate. The clause requires the auditor to comment whether the funds raised on short-term basis have been used for long-term investment and *vice versa*, so that the users can assess whether the company has followed the above-mentioned principle of financial management.
- (b) The term “funds” has different meanings attached to it. For the purpose of this clause, the term refers to cash, cash equivalents or working capital.
- (c) The auditor uses the balance sheet to ascertain whether the funds raised on short-term basis have been used for long-term investment and *vice versa*. Long-term sources of funds would include share capital, reserves and surplus, provision for depreciation, long-term debt securities, long-term loans. Long-term application of funds includes investment in fixed assets, long-term investments and other assets of similar nature, repayment of long-term loans and advances or redemption of debt securities, etc. Short-term sources of funds include temporary credit facilities like cash credits, overdraft. Reduction in current assets or increase in current liabilities are also sources of short-term increase in funds. Application of funds which is not long-term is covered under the short-term application. Increase in current assets or decrease in current liabilities also indicate short-term application of funds.
- (d) The auditor should determine the long-term sources and the long-term

application of funds by a company. If the quantum of long-term of funds of a company is not significantly different from the long-term application of funds, it is an indication that the long-term assets of the company are financed from the long-term sources. However, if the quantum of long-term funds is significantly less than the long-term application of funds, it is an indication that short-term funds have been used to finance the long-term assets of the company. Similarly, if the quantum of long-term funds is significantly more than the long-term application of funds, it is an indication that long-term funds have been used to finance the short-term assets of the company. The difference between the figures of long-term funds and long-term assets of the company indicate the extent to which short-term funds have been used to finance long-term assets of the company and *vice versa*.

- (e) Working capital is normally understood to be a short-term application of funds which keeps on changing its form throughout the working capital cycle. It may, however, be noted that core or permanent working capital of an enterprise should be financed from long-term funds (preferably the owners' capital). Core or permanent working capital is that component of the working capital of the enterprise that always remains invested in business and is never allowed to exit. Therefore, if the quantum of long-term funds is significantly more than the long-term applications of funds, the auditor should determine whether long-term funds have been used to finance the core working capital of the company. For this purpose, the auditor should compute the figure of working capital and compare it with the difference between the quantum of long-term funds and long-term applications of funds. Still, if the long-term funds are more than the working capital of the company the auditor's report should state that the company has used long-term funds to finance current assets.
- (f) The clause also requires the auditor to state the nature of application of funds if the company has financed long-term assets out of short-term funds and *vice versa*. The nature of application of funds can be determined only if the funds raised can be directly identified with an asset. The determination of direct relationship between particular funds and an asset from the balance sheet is not feasible unless the movement of funds of company, since its inception is examined and verified. Further, such movement in funds should also be supported by relevant documentation. Identification of the nature of application of funds would

require exercise of professional judgement by the auditor in this regard. Examination of the cash flow statement would also help the auditor in determining whether the company has financed long-term assets out of short-term funds and *vice versa*. The auditor can determine the sources and application of cash from the cash flow statement on the company prepared for the past years. The auditor, however, should perform audit procedures which he considers are necessary for determining the nature of application of funds depending upon the facts and circumstances of each case, more particularly on the basis of availability of relevant information. Where the auditor is unable to determine the nature of application of funds because of non-availability of relevant information in this regard, he should give a disclaimer while commenting on this aspect of the clause.

- (g) The difficulty of identifying the nature of application of funds would be faced by the auditors only in respect of past accounting periods. Irrespective of the fact whether, the auditor is able to determine the nature of application as described in (f) above, it is suggested that the auditor should carry out the procedures mentioned at (d) above in respect of the opening balance sheet of the company on the first occasion, the auditor comments on matters specified in the Order. This would indicate the extent to which short-term funds have been used to finance long-term assets of the company and *vice versa* as on the last day of the previous accounting period. In addition to this, the auditor should make use of the “funds flow statement”²⁰ for the period covered by the financial statements. A “funds flow statement” summarises the flows of the funds for the period covered by it including the sources from which funds were obtained by an enterprise and the specific uses to which such funds were applied. The following are some examples of reporting that can be made under this clause:

“Based on our examination of the balance sheet of the company as at _____ (*the date of previous financial statements*), we find that the company as on that date had long-term sources of funds amounting to Rs. 150,000/-. The long-term application of funds was Rs. 190,000/-. Because of non-availability of adequate information for the purpose of identification of funds raised with a particular asset, we are unable to comment the sources from which

²⁰ The title “funds flow statement” is used in this Statement; this financial statement is also known as “statement of changes in financial position” or “statement of sources and application of funds”.

Rs. 40,000/- (excess of long-term application of funds over the long-term sources of funds) have been applied. During the accounting period covered by our report, the company generated Rs. 90,000/- long-term sources and applied Rs. 70,000/- towards long-term applications. Rs. 20,000/- of the funds raised from long-term sources during the accounting period covered by our report were used for short term-applications.”

78. *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. [Paragraph 4(xviii)]*

Comments

- (a) Allotment of shares by a company under the provisions of section 81(1A) of the Act is known as preferential allotment of shares. It may be noted that section 81 of the Act is not applicable to a private company. Further, a listed company, by virtue of SEBI (Disclosure and Investor Protection) Guidelines, 2000, is prohibited from making any preferential issues of equity shares, fully convertible debentures, partly convertible debentures or any other instrument which may be converted into or exchanged with equity shares at a later date if the same is not in compliance with the conditions for continuous listing. Therefore, the clause is also not relevant in the case of a listed company.²¹ Under this clause, the auditor is required to comment whether preferential allotment of shares to parties and companies covered in the Register maintained under Section 301, has affected prejudicially the interest of the company. From the above, it is clear that the clause is to be commented upon by the auditor only in the case of unlisted public companies.
- (b) For issuing any shares under section 81(1A) of the Act, a company is required to either pass a special resolution or where no such special

²¹ SEBI Guidelines are subject to change from time to time. Prior to the amendment of the Guidelines, a listed company could issue shares on a preferential basis at a price not less than the higher of the following:

- (i) the average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the six months preceding the relevant date;
- or
- (ii) the average of the weekly high and low of the closing prices of the related shares quoted on a stock exchange during the two weeks preceding the relevant date.

resolution is passed, the votes cast for the proposal exceed the votes cast against the proposal and the Central Government is satisfied, on an application made by the board of directors in this behalf, that the proposal is most beneficial to the company.

- (c) In so far as the price at which preferential allotment is made is concerned, it may be noted that valuation of shares of a company involves use of judgment, knowledge of the business, analysis and interpretation and the use of different methods, which may result in assigning different values based on different methods. There are certain basic factors, which affect the value of a company's shares for which the price calculated is adjusted. The factors are earnings, dividends declared, asset value and goodwill of the company.²² Methods generally used for determining the fair value of the business, which take into consideration one or more factors mentioned above are:
- (i) Net Assets Basis—considers the valuation of assets, subtracting there from liabilities, etc., to arrive at the value of the equity shares.
 - (ii) Maintainable Profits Basis—this is based on the future maintainable profits/earnings of the company.
 - (iii) Yield Basis—this method recognises the yield/dividends as a base for arriving at the fair value of the shares.
 - (iv) Discounted Cash Flow Method — this method estimates the value of shares by estimating the future cash flows from operations and discounting the cash flows at a specified rate.
- (d) It is not rare to find a combination of different methods used in the context of valuation of shares; for example, an averaging of maintainable profits basis and the net assets basis.
- (e) The auditor should ascertain whether the company has allotted any shares under section 81(1A) of the Act. The auditor should examine the minutes

²² This is not an exhaustive mention of the factors influencing the price of the shares. There could be numerous other factors like the nature of the company's business, the caliber of managerial personnel, prospects of expansion, financial structure, cash flows, patents, franchises, incidence of taxation, competition, size of the holding, government policy, prevailing political climate, risk of obsolescence of items manufactured, etc., may also affect the price of the shares of a company.

book of the general meeting along with the notice for the meeting and explanatory statement attached with the notice with a view to ascertain the rationale for determination of prices of shares. The auditor should examine the method used for valuation of shares of the company and should also ascertain the reasonableness of the assumptions underlying the calculation. Whether the price charged for preferential allotment of the shares is prejudicial to the interests of the company is a question that would require the use of professional judgement by the auditor. The auditor should give due consideration to the factors which affect the value of a company's shares for which the price calculated is adjusted. Some of the main factors are mentioned at paragraph (c) above. On an examination of the methods and various factors, the auditor may come to a conclusion that better price for share issued could have been obtained if the difference between the price that could have been obtained and that has actually been charged is so significant that no reasonable person would have allotted shares at the price that has actually been charged. The auditor should also obtain a representation from the management as to why the company considers that the price charged is not prejudicial to the interest of the company. If the auditor does not find the explanation convincing, it will be necessary for him to state that the price charged by the company is prejudicial to the interest of the company.

- (f) In case, the company has made preferential issue of shares by passing an ordinary resolution, the auditor, apart from examining the method used for valuation of shares of the company and ascertaining the reasonableness of the assumptions underlying the calculation, should also examine the Order of the Government as to its satisfaction that the proposal is most beneficial to the company. Where the Government is satisfied in this regard, the auditor need not make his assessment as to the reasonableness of the prices charged for the preferential allotment of shares. The auditor, however, is not precluded from doing so. If the auditor forms his opinion on the basis of the Order issued by the Government, he should state the fact of his reliance on the Government Order for the purpose of reporting.

79. *Whether securities have been created in respect of debentures issued?*
[Paragraph 4(xix)]

Comments

- (a) Section 117C of the Act requires that where a company issues debentures, it shall create a debenture redemption reserve for redemption of debentures, to which adequate amounts shall be credited from out of its profits every year until such debentures are redeemed. The companies, normally, apart from creating a debentures redemption reserve by crediting amounts out of profits every year, do invest in securities as a safeguard against liquidity as and when redemption of debentures falls due.
- (b) Where the company has issued any debentures, the auditor should verify whether adequate amount, so as to cover the redemption of debentures as and when it falls due, is credited to the debenture redemption reserve. The auditor should also examine the debenture trust deed executed under section 117A of the Act. The auditor should pay particular attention to verify whether proper securities have been created in favour of the debenture trust. The security creation can be verified by examining the relevant documents creating the charge in favour of the trust duly registered in the concerned Registrar's office if the security is an immovable property.

80. *Whether the management has disclosed the end use of money raised by public issues and the same has been verified.* [Paragraph 4(xx)]

Comments

- (a) In case the company has made a public issue of any of its security, the auditor is required to report upon the disclosure of end-use of the money by the management in the financial statements. The auditor is also required to state whether he has verified the disclosure made by the management in this regard.
- (b) Normally, the companies do mention the end-use of the money proposed to be raised through the public issue in the prospectus. An examination of the prospectus would provide the auditor an understanding of the end-use of moneys raised by public. The auditor should verify that the amount of end-use of money disclosed in the financial statements by the management is not significantly different from the actual end use. The

auditor should obtain a representation of the management as to the completeness of the disclosure with regard to the end-use of money's raised by public issues. If the auditor is of the opinion that complete disclosure has not been made in the financial statements, the auditor should state the fact. The auditor should also make adequate disclosure in his report of the information which should have been disclosed by the management in the financial statements. If, for any reason, the auditor is not able to determine the end-use of money raised from public issues, he should state that he is not able to comment upon the disclosure of end-use of money by the company since he could not verify the same. He should also mention the reasons which contributed to the auditor's inability to verify the disclosure.

81. *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.* [Paragraph 4(axe)]

- (a) This clause requires the auditor to report whether any fraud has been noticed or reported either on the company or by the company during the year. Therefore, the auditor is required to ensure that if any frauds have occurred they are reported. If yes, the auditor is required to state the amount involved and the nature of fraud. The clause does not require the auditor to discover the frauds on the company and by the company. It may be noted that this clause of the Order, by requiring the auditor to report whether any fraud on or by the company has been noticed or reported, does not relieve the auditor from his responsibility to consider fraud and error in an audit of financial statements. In other words, irrespective of the auditor's comment under this clause, the auditor is also required to comply with the requirements of Auditing and Assurance Standard (AAS) 4, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements".
- (b) The auditor should examine the reports of the internal auditor with a view to ascertain whether any fraud has been reported or noticed by the management. The auditor should enquire of the management about any frauds on or by the company that it has noticed or that have been reported to it. The auditor should also discuss the matter with other employees of the company. The auditor should also examine the minute book of the board meeting of the company in this regard.

- (c) Where the auditor notices that any fraud on the company or by the company has been noticed or reported, the auditor should determine the nature and amount of frauds and disclose the same in his audit report.
- (d) It may be noted that while commenting upon this clause, if the auditor notices any fraud or has a doubt about the existence of a fraud, he should carry out the procedures as mentioned in Auditing and Assurance Standard (AAS) 4, “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements”.

Form of Report

82. The Order requires that the auditor should make a statement on the matters contained in the Order. This requirement applies even where the answers to any of the questions are unfavourable or qualified. The Order further provides that where an auditor is unable to express any opinion, he should indicate such fact and also give reasons as to why he is unable to express an opinion.

83. It is necessary to consider whether any comment in the audit report is necessary when the company whose accounts are being reported upon is not a company to which the Order applies. While a comment is not strictly necessary, the auditor might consider whether the interpretation, which he gives to the Order in this respect, can be subject to doubt or whether it is beyond doubt that the Order is not applicable. As a measure of prudence, it is suggested that the audit report includes a remark on the following lines:

“This report does not include a statement on the matters specified in paragraph 4 of the Companies (Auditor’s Report) Order, 2003, issued by the Department of Company Affairs, in terms of Section 227(4A) of the Companies Act, 1956, since in our opinion and according to the information and explanations given to us, the said Order is not applicable to the company.”

84. There may be situations where one or more of the clauses are not applicable. For example, the requirement regarding internal audit system does not apply in case of all the companies. In such situations, 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, where the

maintenance of cost records has not been prescribed by the Central Government under Section 209(1)(d) of the Act, the auditor may state:

“The Central Government has not prescribed maintenance of cost records under Section 209(1)(d) of the Companies Act, 1956 for any of the products of the company”.

85. A question may also arise whether it is necessary for the auditor to include in his report the management’s explanation for any matter on which he makes an adverse comment. Normally, such explanation need not be included but there may be circumstances where the auditor feels such inclusion is necessary. Examples of such circumstances would be:

- (a) to make the comment itself more meaningful and complete. For example, physical verification of inventories, though planned, may not have been carried out because of a strike or a lockout. An adverse comment without this explanation would be misleading;
- (b) to explain the fact why in spite of an adverse comment, the true and fair view of the financial statements is not vitiated. For example, physical verification of a part of the inventories at the year-end may not have been carried out, but there is sufficient other evidence produced by the management which satisfies the auditor regarding the existence, condition and value of the inventories.

86. In making his report, the auditor has to understand fully the inter-relationship between the different requirements of various sub-sections of Section 227 of the Act. In terms of sub-section (1A), he has to make specific inquiries regarding the matters specified therein but he has no obligation to report upon such matters unless his inquiries reveal an unsatisfactory state of affairs on which he feels a report is necessary. Under the Order, he has to report on all the matters specified in the Order. In making this report, he should, therefore, take into account the results of inquiries made by him in terms of sub-section (1A). The requirements of sub-section (1A) do not, however, in any way diminish the auditor’s responsibilities under sub-sections (2), (3) and (4) of the section. Therefore, in framing his report under sub-sections (2), (3) and (4) of the section, the auditor has to take into account the inquiries made by him under sub-section (1A) and the report made by him under the Order.

87. It is suggested that the sequence of the items as appearing in the report should be: first, the comments, if any, under sub-section (1A); second, the comments under the Order; and finally, the report under sub-sections (2), (3) and (4) of Section 227. The comments under the Order may, alternatively, be given in the form of an Annexure to the report. However, when the comments are given in an Annexure, it is necessary to refer to the Annexure in the main report and it is advisable to sign the Annexure in addition to signing the main report.

88. If any of the comments on matters stated in the Order are adverse, the auditor should consider whether a qualification in the report under sub-sections (2), (3) and (4) of section 227 is necessary.

89. If the auditor is of the opinion that any of the adverse comments under sub-sections (2), (3) and (4) of section 227 the auditor may prefer to preface his report under those sub-sections by stating the qualifications. Such a qualification should be made against the specific item which is being qualified²³.

90. Even where there are no adverse comments under the Order, it may be advisable for the auditor to preface his report under sub-sections (2), (3) and (4) of Section 227 with the words:

“Further to our comments in the Annexure, we state that.....”

91. It should not, however, be assumed that every adverse comment under the Order would necessarily result in a qualification in the report under sub-sections (2), (3) and (4) of Section 227. Firstly, the adverse comment may be regarding a matter which has no relevance to a true and fair view presented by the financial statements, for example, the failure of the company to deposit provident fund dues in time or to comply with the requirements regarding acceptance of deposits. Secondly, while the non-compliance may be material enough to warrant an adverse comment under the Order, it may not be material enough to affect the true and fair view presented by the financial statements. Finally, the non-compliance may be in an area which calls for remedial action

²³ The qualifications in the auditor's report should be made in accordance with the manner stated in the Auditing and Assurance Standard (AAS) 28, "The Auditor's Report on Financial Statements". AAS 28 lays down the principles to be followed in making qualification/disclosure in the audit report. Reference should also be made in this regard to the Statement on Qualifications in the Auditor's Report issued by the Institute of Chartered Accountants of India. The Statement provides, *inter alia*, the guidance on the application of principles contained in AAS 28.

on the part of the management, for example, a lack of internal control in a specific area regarding purchases and may be important for that reason but may not be sufficiently important in the context of the report under sub-sections (2), (3) and (4). In deciding, therefore, whether a qualification in the report under sub-sections (2), (3) and (4) is necessary, the auditor should use his professional judgement in the facts and circumstances of each case.

92. Where there is a qualification both under sub-section (1A) and under the Order, it is suggested that the qualification under sub-section (1A) precede the qualification under the Order.

93. It is important to note that replies to many of the requirements of the Order will involve expressions of opinion and not necessarily statement of facts. It is necessary, therefore, that this is indicated when making the report under the Order. This can be done in either of the following ways:

(a) By a general preface to the comments under the Order on the following lines:

“In terms of the information and explanations given to us and the books and records examined by us in the normal course of audit and to the best of our knowledge and belief, we state that.....”

or

(b) by a preface to individual comments, for example,

“In our opinion” or “In our opinion and according to the information and explanations given to us during the course of the audit...”

94. The Order requires that where the answer to a question is unfavourable or qualified, the auditor’s report should also state the reasons for such unfavourable or qualified answer. The requirement is similar to the requirement of sub-section (4) of Section 227 and the same considerations would apply. Thus, while it is not necessary for the auditor to give very detailed reasons for an unfavourable or qualified answer, he is expected to explain the nature of the qualification or adverse comment in clear and unambiguous terms. For example, if the auditor reports that the company’s internal audit system is not commensurate with its size and nature of its business, he need not report every single shortcoming of the system but may indicate the general reasons why he considers the system as not

commensurate, for example, that the internal audit department is not adequately staffed or that its coverage is not adequate, etc.

95. Similar considerations would apply when the auditor is unable to express an opinion. For example, if the internal audit department is unable to produce any audit programme, working papers, report, or other evidence of work done, the auditor may not be in a position to report whether the system is commensurate with the size and nature of the business of the company. In such circumstances, he should clearly state that he is unable to express an opinion because such records or evidence has not been produced before him.

96. In expressing an opinion, auditor should be quite clear as to whether the circumstances of the case warrant a negative answer or whether his opinion can be expressed subject to a qualification. To illustrate, if the system of internal audit has basic defects which render it totally ineffective, for example, due to grossly inadequate number of qualified staff, then the answer may be unfavourable. However, if there are minor defects in the system, for example, if the coverage is inadequate in certain areas, the auditor may state in his report that the coverage is inadequate in a particular area (to be specified) but otherwise the system is commensurate with the size of the company and the nature of its business.

97. The auditor's report under sub-section (3) of Section 227 is required to state whether the auditor has obtained all the information and explanations which, to the best of his knowledge and belief, were necessary for the purposes of his audit. The term "audit" would include the reporting requirements under the Order. Therefore, when making his report, the auditor has to consider whether he has obtained the information and explanations needed not merely for the purposes of normal audit, but also for the purpose of reporting in terms of the Order. If he has not received the information and explanations necessary for reporting in terms of the Order, he should mention that fact both when reporting on the specific question in the Order and also when reporting generally in terms of sub-section (3) of Section 227.

98. A specimen form of report is given in Appendix VII. It will be noticed that the comments under the Order are given in the form of an Annexure, as stated in paragraph 39 above. Where an "Annexure" form is not used, the comments will appear in the body of the report itself.

Board's Report

99. Section 217 of the Act requires that the board of directors shall be bound to give in its report the fullest information and explanations regarding every reservation, qualification or adverse remark contained in the auditor's report. The auditor's comments in terms of the Order form part of his report and, therefore, the board will be bound to give in its report the fullest information and explanations regarding every adverse comment therein.

100. The auditor's comments in terms of the Order may be in respect of matters of fact or they may be an expression of opinion. It is necessary that there should be no inconsistency in the facts as stated by the auditor and as explained in the board's report. It is, therefore, suggested that wherever possible, a draft report should be submitted to the board to verify and confirm the facts stated therein.

101. It is, however, possible that, on the same facts, there may be a genuine difference of opinion between the auditor and the board. In such a case, each is entitled to hold his or its view. Therefore, the expression of a different opinion in the board's report should not be regarded as any reflection on the opinion expressed by the auditor.

Draft

Appendix I

Text of the Companies (Auditor's Report) Order, 2003

**PUBLISHED IN THE GAZETTE OF INDIA
EXTRAORDINARY PART II, SECTION 3 - SUB - SECTION (i)**

**MINISTRY OF FINANCE
(DEPARTMENT OF COMPANY AFFAIRS)**

New Delhi, the 12th June, 2003

G.S.R.480(E)—In exercise of the powers conferred by sub-section (4A) of Section 227 of the Companies Act, 1956 (1 of 1956), read with the Notification of the Government of India in the Department of Company Affairs, number G.S.R.443(E), dated 18th October, 1972, as amended from time to time and in supersession of order number G.S.R.909(E), dated 7th September, 1988, published in the Gazette of India, part II, section 3, sub section (i), except as respects things done or omitted to be done before the supersession, and after consultation with the Institute of Chartered Accountants of India [constituted under the Chartered Accountants Act, 1949 (38 of 1949)], in regard to class of companies to which this order applies and other ancillary matters, the Central Government hereby makes the following Order, namely:

1. Short title, Application and Commencement.

- (1) This order may be called the Companies (Auditor's Report) Order, 2003.
- (2) It shall apply to every company including a foreign company as defined in section 591 of the Act, except the following :-
 - (i) a Banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
 - (ii) an insurance company as defined in clause (21) of section 2 of the Act;
 - (iii) a company licensed to operate under section 25 of the Act; and
 - (iv) a private limited company with a paid up capital and reserves not more than fifty lakh rupees and has not accepted any public deposit and does not have loan outstanding ten lakh rupees or more from any bank or

financial institution and does not have a turnover exceeding five crore rupees.

(3) It shall come into force on the 1st day of July, 2003.

2. Definitions

In this Order, unless the context otherwise requires:

(a) **“Act”** means the Companies Act, 1956 (1 of 1956);

(b) **“chit fund company”, “nidhi company” or “mutual benefit company”** means a company engaged in the business of managing, conducting or supervising as a foreman or agent of any transaction or arrangement by which it enters into an agreement with a number of subscribers that every one of them shall subscribe to a certain sum of instalments for a definite period and that each subscriber, in his turn, as determined by lot or by auction or by tender or in such other manner as may be provided for in the agreement, shall be entitled to a prize amount, and includes companies whose principal business is accepting fixed deposits from, and lending money to, members;

(c) **“finance company”** means a company engaged in the business of financing, whether by making loans or advances or otherwise, of any industry, commerce or agriculture and includes any company engaged in the business of hire-purchase, lease financing and financing of housing;

(d) **“investment company”** means a company engaged in the business of acquisition and holding of, or dealing in, shares, stocks, bonds, debentures, debenture stocks, including securities issued by the Central or any State Government or by any local authority, or in other marketable securities of a like nature;

(e) **“manufacturing company”** means a company engaged in any manufacturing process as defined in the Factories Act, 1948 (63 of 1948);

(f) **“mining company”** means a company owning a mine, and includes a company which carries on the business of a mine either as a lessee or as occupier thereof;

(g) **“processing company”** means a company engaged in the business of processing materials with a view to their use, a sale, delivery or disposal;

(h) “*service company*” means a company engaged in the business of supplying, providing, maintaining and operating any services, facilities, conveniences, bureaux and the like for the benefit of others;

(i) “*trading company*” means a company engaged in the business of buying and selling goods.

3. Auditor’s Report to Contain Matters Specified in Paragraphs 4 and 5

Every report made by the auditor under section 227 of Act, on the accounts of every company examined by him to which this Order applies for every financial year ending on any day on or after the commencement of this Order, shall contain the matters specified in paragraphs 4 and 5.

4. Matters to be Included in the Auditor’s Report

The auditor’s report on the account of a company to which this Order applies shall include a statement on the following matters, namely:

- (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;
- (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 its business. If not, the inadequacies in such procedures 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 have been properly dealt with in the books of account;

(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.

(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 are also regular;

(d) if overdue amount is more than 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 and for the sale of goods. Whether there is a continuing failure to correct major weaknesses in internal control;

(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).

(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 whether the same has been complied with or not?

(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 five crore rupees 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;

(viii) where maintenance of cost records has been prescribed by the Central Government under clause (d) of sub-section (1) of section 209 of the Act, whether such accounts and records have been made and maintained;

(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 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.

(b) in case dues of sales tax/income tax/custom tax/wealth tax/excise duty/cess 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).

(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 per cent 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;

(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 of default to be reported;

(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.

(xiii) whether the provisions of any special statute applicable to chit fund have been duly complied with? In respect of nidhi/ mutual benefit fund/societies;

(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 schedule 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;

(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 except to the extent of the exemption, if any, granted under section 49 of the Act;

(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;

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

(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;

(xix) whether securities have been created in respect of debentures issued?

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

(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.

5. Reasons to be Stated for Unfavourable or Qualified Answers

Where, in the auditor's report, the answer to any of the questions referred to in paragraph 4 is unfavourable or qualified, the auditor's report shall also state the reasons for such unfavourable or qualified answer, as the case may be. Where the auditor is unable to express any opinion in answer to a particular question, his report shall indicate such fact together with the reasons why it is not possible for him to give an answer to such question.

(File No.2/ 28 /2002-CL.V)

RAJIV MEHRISHI
Joint Secretary

Appendix II

MAOCARO, 1988 AND CARO, 2003—A Comparative Analysis

Comparative Table

CARO, 2003	MAOCARO, 1988
1. Short Title, Application and Commencement	1. Short Title, Application and Commencement
(1) This Order may be called the Companies (Auditor's Report) Order, 2003.	(1) This Order may be called the Manufacturing and Other Companies (Auditor's Report) Order, 1988.
	(2)(a) It shall apply to every company including a foreign company as defined in section 591 of the Companies Act, 1956 (1 of 1956) which is engaged in one or more of the following activities: (i) manufacturing, mining or processing; (ii) supplying and rendering services; (iii) trading; and (iv) the business of financing, investment, chit fund, nidhi or mutual benefit societies.
2. It shall apply to every company including a foreign company as defined under section 591 of the Act, except the following:	(b) It shall not apply to:

- | | |
|---|--|
| <p>(i) a Banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);</p> <p>(ii) an insurance company as defined in clause (21) of section 2 of the Act;</p> <p>(iii) a company licensed to operate under section 25 of the Act; and</p> <p>(iv) a private limited company with a paid up capital and reserves not more than fifty lakh rupees and has not accepted any public deposit and does not have loan outstanding ten lakh rupees or more from any bank or financial institution and does not have a turnover exceeding five crore rupees.</p> <p>(3) It shall come into force on the 1st day of July, 2003.</p> | <p>(i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);</p> <p>(ii) an insurance company as defined in section 2(21) of the Companies Act, 1956 (1 of 1956); and</p> <p>(iii) a company licensed to operate under section 25 of the Companies Act, 1956 (1 of 1956).</p> <p>(3) It shall come into force on the 1st day of November, 1988.</p> |
|---|--|

2. Definitions

In this Order, unless the context otherwise requires,

- (a) “Act” means the Companies Act, 1956 (1 of 1956);
- (b) “chit fund company”, “nidhi company” or “mutual benefit company” means a company engaged in the business of managing, conducting or supervising as a foreman or agent of any transaction or arrangement by which it enters into an agreement with a number

2. Definitions

In this Order:

- (a) “Chit fund”, “nidhi” or “mutual benefit” company means a company engaged in the business of managing, conducting or supervising as a foreman or agent of any transaction or arrangement by which it enters into an agreement with a number of

of subscribers that every one of them shall subscribe to a certain sum of instalments for a definite period and that each subscriber, in his turn, as determined by lot or by auction or by tender or in such other manner as may be provided for in the agreement, shall be entitled to a prize amount, and includes companies whose principal business is accepting fixed deposits from, and lending money to, members;

subscribers that every one of them shall subscribe a certain sum of instalments for a definite period and that each subscriber, in his turn, as determined by lot or by auction or by tender or in such other manner as may be provided for in the agreement, shall be entitled to a prize amount, and includes companies whose principal business is accepting fixed deposits from, and lending money to, members;

(c) “finance company” means a company engaged in the business of financing, whether by making loans or advances or otherwise, of any industry, commerce or agriculture and includes any company engaged in the business of hire-purchase, lease financing and financing of housing;

(b) “finance company” means a company engaged in the business of financing, whether by making loans or advances or otherwise, of any industry, commerce or agriculture and includes any company engaged in the business of hire-purchase, lease financing and financing of housing;

(d) “investment company” means a company engaged in the business of acquisition and holding of, or dealing in, shares, stocks, bonds, debentures, debenture stocks, including securities issued by the Central or any State Government or by any local authority, or in other marketable securities of a like nature;

(c) “investment company” means a company engaged in the business of acquisition and holding of, or dealing in, shares, stocks, bonds, debentures, debenture stocks, including securities issued by the Central or any State Government or by any local authority, or in other marketable securities of a like nature;

(e) “manufacturing company” means a company engaged in any manufacturing process as

(d) “manufacturing company” means a company engaged in any manufacturing process as

defined in the Factories Act, 1948 (63 of 1948);

- (f) “mining company” means a company owning a mine, and includes a company which carries on the business of a mine either as a lessee or occupier thereof;
- (g) “processing company” means a company engaged in the business of processing materials with a view to their use, a sale, delivery or disposal;
- (h) “service company” means a company engaged in the business of supplying, providing, maintaining and operating any services, facilities, conveniences, bureaux and the like for the benefit of others;
- (i) “trading company” means a company engaged in the business of buying and selling goods.

defined in the Factories Act, 1948 (63 of 1948);

- (e) “mining company” means a company owning a mine, and includes a company which carries on the business of a mine either as a lessee or occupier thereof;
- (f) “processing company” means a company engaged in the business of processing materials with a view of their use, sale, delivery or disposal;
- (g) “service company” means a company engaged in the business of supplying, providing, maintaining and operating any services, facilities, conveniences, bureaux and the like for the benefit of others;
- (h) “trading company” means a company engaged in the business of buying and selling goods.

3. Auditor’s report to contain matters specified in paragraphs 4 and 5

Every report made by the auditor under section 227 of Act, on the accounts of every company examined by him to which this Order applies for every financial year ending on any day on or after the commencement of this Order, shall contain the matters specified in paragraphs 4 and 5.

3. Auditor’s Report to Contain Matters Specified in Paragraphs 4 and 5

Every report made by the auditor under section 227 of the Companies Act, 1956 (1 of 1956) on the accounts of every company examined by him to which this Order applies for every financial year ending on any day on or after the commencement of this Order, shall contain the matters specified in paragraphs 4 and 5.

4. Matters to be Included in the Auditor's Report

The auditor's report on the account of a company to which this Order applies shall include a statement on the following matters, namely:

- (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;**

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

4. The Matters to be Included in the Auditor's Report

The Auditor's Report on the accounts of a company to which this Order applies shall include a statement on the following matter, namely:

(A) In the case of a manufacturing, mining or processing company:

- (i) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets: 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;
- (ii) whether any of the fixed assets have been revalued during the year, if so, the basis of revaluation should be indicated;
- (iii) whether physical verification has been conducted by the management at reasonable intervals in respect of finished goods, stores, spare parts and raw materials;

- (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 its business. If not, the inadequacies in such procedures 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 have been properly dealt with in the books of account;
- (iv) are the procedures of physical verification of stocks followed by the management reasonable and adequate in relation to the size of the company and the nature of its business? If not, the inadequacies in such procedures should be reported;
- (v) whether any material discrepancies have been noticed on physical verification of stocks as compared to book records, and if so, whether the same have been properly dealt with in the books of account?
- (vi) whether the auditor, on the basis of his examination of stocks, is satisfied that such valuation is fair and proper in accordance with the normally accepted accounting principles? Is the basis of valuation of stocks same as in the preceding year? If there is any deviation in the basis of valuation, the effect of such deviation, if material, should be reported;
- (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.**
- (vii) if the company has taken any loans, secured or unsecured, from companies, firms or other parties listed in the register maintained under section 301 of the Companies Act, 1956 (1 of 1956), and/or from the companies under the same management as defined

- (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 are also regular;
 - (d) if **overdue amount is more than 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** and for the sale of goods. **Whether there is a continuing failure to correct major weaknesses in internal control;**
- under sub-section (1B) of section 370 of the Companies Act, 1956 (1 of 1956), whether the rate of interest and other terms and conditions of such loans are *prima facie* prejudicial to the interest of the company;
- (viii) if the company has granted any loans, secured or unsecured, to companies, firms or other parties listed in the register(s) maintained under section 301 and/or to the companies under the same management as defined under sub-section (1B) of section 370 of the Companies Act, 1956 (1 of 1956), whether the rate of interest and other terms and conditions of such loans are *prima facie* prejudicial to the interest of the company;
 - (ix) whether the parties to whom the loans, or advances in the nature of loans, have been given by the company are repaying the principal amounts as stipulated and are also regular in payment of the interest and if not whether reasonable steps have been taken by the company for recovery of the principal and interest;
 - (x) is there an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the purchase of stores, raw materials, including components, plant

- (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).

- (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 whether the same has been complied with or not?**

and machinery, equipment and other assets, and for the sale of goods;

- (xi) whether the transactions of purchase of goods and materials and sale of goods, materials and services, made in pursuance of contracts or arrangements entered in the register(s) maintained under section 301 of the Companies Act, 1956 (1 of 1956) as aggregating during the year to Rs.50,000/- (Rupees fifty thousand) or more in respect of each party, have been made at prices which are reasonable having regard to prevailing market prices for such goods, materials, or services or the prices at which transactions for similar goods or services have been made with other parties;
- (xii) whether any unserviceable or damaged stores, raw materials, or finished goods, are determined and whether provisions for the loss, if any, have been made in the accounts;
- (xiii) in case the company has accepted deposits from the public, whether the directives issued by the Reserve Bank of India and the provisions of section 58A of the Companies Act, 1956 and the rules framed thereunder, where applicable, have been complied with. If not, the nature of contraventions should be stated;

- (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 **five crore rupees** 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;
- (viii) where maintenance of cost records has been prescribed by the Central Government under clause (d) of sub-section (1) of section 209 of the Act, whether such accounts and records have been made and maintained;
- (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 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
- (xiv) is the company maintaining reasonable records for the sale and disposal of realisable by-products and scraps, where applicable;
- (xv) in the case of companies having a paid-up capital exceeding Rs.25 lakh as at the commencement of the financial year concerned, or having an average annual turnover exceeding Rs.2 crores 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;
- (xvi) where maintenance of cost records has been prescribed by the Central Government under section 209(1)(d) of the Companies Act, 1956 (1 of 1956), whether such accounts and records have been made and maintained;
- (xvii) is the company regular in depositing Provident Fund and Employees' State Insurance dues with the appropriate authority and if not, the extent of arrears of Provident Fund and Employees' State Insurance dues shall be indicated by the auditor;

they became payable, shall be indicated by the auditor.

- (b) in case dues of sales tax/income tax/custom tax/wealth tax/excise duty/cess 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).

- (xviii) whether any undisputed amounts payable in respect of income tax, wealth tax, sales tax, customs duty and excise duty were outstanding, as at the last day of the financial year concerned, for a period of more than six months from the date they became payable; if so, the amounts of such outstanding dues should be reported;

- (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 per cent 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;**

- (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 of default to be reported;**

- (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.**

- (xix) whether personal expenses have been charged to revenue account; if so, the details thereof should be reported;

- (xx) whether the company is a sick industrial company within the meaning of clause (o) of sub-section (1) of section 3 of the Sick Industrial Companies (Special Provisions) Act, 1985 (1 of 1986); if so, whether a reference has been made to the Board for Industrial and Financial Reconstruction under section 15 of the Act.

(xiii) whether the provisions of any special statute applicable to chit fund have been duly complied with? In respect of nidhi/ mutual benefit fund/societies;

(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 schedule 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;

(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 except to the extent of the exemption, if any, granted under section 49 of the Act;

(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;

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

(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;

(xix) whether securities have been created in respect of debentures issued?

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

(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.

(B) In the case of a service company:

- (i) all the matters specified in clause (A) to the extent to which they are applicable;
- (ii) whether the company has a reasonable system of recording receipts, issues and consumption of material and stores and allocating materials consumed to the relative jobs, commensurate with its size and nature of its business;
- (iii) whether the company has a reasonable system of allocating man-hours utilised to the relative jobs, commensurate with its size and nature of its business;
- (iv) whether there is a reasonable system of authorisation at proper levels, and an adequate system of internal control commensurate with the size of the company and the nature of its business, on issue of stores

and allocation of stores and labour to jobs.

(C) In the case of a trading company:

- (i) all the matters specified in clause (A) to the extent to which they are applicable;
- (ii) have the damaged goods been determined and if the value of such goods is significant, has provision been made for the loss.

(D) In the case of a finance, investment, chit fund, *nidhi* or mutual benefit company:

- (i) all the matters specified in clause (A) to the extent to which they are applicable;
- (ii) whether adequate documents and records are maintained in a case where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities;
- (iii) whether the provisions of any special statute applicable to chit fund, *nidhi* or mutual benefit society have been duly complied with;
- (iv) 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 investments, have been held by the company in its own name except to the extent of the exemption, if any, granted under section 49 of the Companies Act, 1956 (1 of 1956).

5. Reasons to be Stated for Unfavourable or Qualified Answers.

Where, in the auditor's report, the answer to any of the questions referred to in paragraph 4 is unfavourable or qualified, the auditor's report shall also state the reasons for such unfavourable or qualified answer, as the case may be. Where the auditor is unable to express any opinion in answer to a particular question, his report shall indicate such fact together with the reasons why it is not possible for him to give an answer to such question.

5. Reasons to be Stated for Unfavourable or Qualified Answer

Where, in the Auditor's Report, the answer to any of the questions referred to in paragraph 4 is unfavourable or qualified, the Auditor's Report shall also state the reasons for such unfavourable or qualified answer, as the case may be. Where the auditor is unable to express any opinion in answer to a particular question, his report shall indicate such fact together with the reasons why it is not possible for him to give an answer to such question.

Appendix III

Text of the Circular on the Date of Application of Companies (Auditor's Report) Order, 2003

**GOVERNMENT OF INDIA
MINISTRY OF FINANCE
(DEPARTMENT OF COMPANY AFFAIRS)**

5th floor, 'A' Wing, Shastri Bhavan,
Dr. R.P. Road, New Delhi.

General Circular No:32/2003

Dated: 10th November, 2003

To

All Regional Directors
All Registrars of Companies

Subject: Compliance of Companies (Auditor's Report) Order, 2003 effective from 1st July, 2003

Sir,

As you are aware, vide notification number G.S.R. 480(E) dated 12th June 2003, Government have issued the Companies (Auditor's Report) Order, 2003 [Order] which came into force on 1st July, 2003. The new Order replaces the Manufacturing and Other Companies (Auditor's Report) Order, 1988(MAOCARO) issued vide Notification No: G.S.R. 909(E) dated 7th September, 1988.

2. Subsequently the Government have received representations stating the difficulty in complying with the new Order at short notice, in view of the absence of a Guidance Note from the Institute of Chartered Accountants of India, and in view of the need for maintaining records of a company in a manner that will ensure the compliance of the Order, Government have given consideration to the difficulty expressed. It has been decided that it is not possible, at this point of time, to review the Order, or postpone the effective date as issued, for accounts prepared in respect of financial year ending on the 1st July, 2003 or thereafter.

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3. However, keeping in view the difficulties of the companies as well as the professionals involved, it has also been decided that while companies to whom the Order is applicable, should make serious efforts to comply with the new Order from the effective date, cases of non compliance for accounts pertaining to financial year which closed on 31st December, 2003 or earlier, Government would take a lenient view provided the accounts at least carry MAOCARO Report, if required.

4. However, accounts in respect of financial years ending on 1st January, 2004 or thereafter, will have to strictly follow CARO, 2003. Companies and professionals who do not comply with the Order will be liable for action as per law.

5. Kindly acknowledge receipt of this letter, a copy of which is being endorsed to the Institute of Chartered Accountants of India and major Industry Associations.

Yours faithfully,

(E. Selvaraj)
Joint Director (Trg.)
Ph: 2338 3452

Appendix IV

Illustrative List of Questions for Evaluating Internal Controls in regard to purchase of inventory, Fixed Assets and Sale of Goods

Purchases and Creditors

1. Is purchasing centralised in the Purchase Department?
2. (a) Are purchases made only from approved suppliers?
(b) Is a list of approved suppliers maintained for this purpose?
(c) Does the master list contain more than one source of supply for all important materials?
3. Are the Purchase Orders based on valid purchase requisitions duly signed by persons authorised in this behalf?
4. (a) Are purchases made on behalf of employees?
(b) If so, is the same procedure followed as for other purchases?
5. Is special approval required for:
(a) Purchase from employees, Directors and Companies in which Directors are interested?
(b) Purchases of capital goods?
6. Are purchases based on competitive quotations from two or more suppliers?
7. Is comparative quotation analysis sheet drawn before purchases are authorised?
8. If the lower quotation is not accepted, is the purchase approved by a senior official?
9. If the price variation clause is included, is it approved by a senior official?
10. Are purchase orders pre-numbered and strict control exercised over unused forms?
11. Are purchase orders signed only by employees authorised in this behalf?
12. Do purchase orders contain the following minimum information:
(a) Name of supplier?
(b) Delivery terms?
(c) Quantity?

- (d) Price?
 - (e) Freight terms?
 - (f) Payment terms?
 - (g) Any extra applicable?
13. Is revision of terms of purchase orders duly authorised?
 14. (a) Are copies of purchase orders and revisions forwarded to Accounts and Receiving Departments?
 - (b) If 'yes', do the copies show the quantities ordered?
 - (c) If 'no', is there an adequate procedure for the Receiving Department to be notified to accept deliveries?
 15. Is a list of pending purchase orders compiled by the Purchase Department at least once every quarter?
 16. Are a materials, supplies, etc., received only in the Receiving Department?
 17. If they are received directly by User Department/Processors/Customers, is there a procedure of obtaining acknowledgement for the quantity received and the condition of the goods?
 18. Are persons connected with receipt of materials and the keeping of receiving records denied authority to issue purchase orders or to approve invoices?
 19. Are materials, supplies inspected and counted, weighted or measured in the Receiving Department?
 20. Are quantities and description checked against purchase order (or other form of notification) and goods inspected for condition?
 21. (a) Does the Receiving Department deliver or supervise the delivery of each item received to the proper Stores or Department location?
 - (b) Are acknowledgements obtained from suppliers for goods/containers returned to them?
 22. Are all receipts of materials evidenced by pre-numbered Goods Received Notes?
 23. Are copies of Goods Received Notes forwarded to Accounts Department and a list of goods received to Purchase Department?
 24. Are all cases of materials returned, shortages and rejections advised to the Accounts Departments, for raising Debit Memos on suppliers or claim bills on carriers/insurance companies, as the case may be?

25. Are all debit notes, etc. –
 - (a) pre-numbered?
 - (b) numerically controlled?
 - (c) properly recorded (in the financial accounts or in memorandum registers, as the case may be)?
26. (a) Are all suppliers' invoices routed direct to the Accounts Department?
- (b) Are they entered in a Bill Register before submitting them to other department for check and/or approval?
- (c) Are advance and partial payments entered on the invoices before they are submitted to other department?
27. Does the system ensure that all invoices and credit notes received are duly processed?
28. In respect of raw materials and supplies, are reconciliation made of quantities and/or values received, as shown by purchase invoices, with receipts into stock records?
29. Are duplicate invoices marked immediately on receipt to avoid payment against them?
30. If payments are made against duplicate invoices even occasionally, are adequate precautions taken to avoid duplicate payments?
31. Does the Accounts Department match the invoices of suppliers with Goods Received Notes or acknowledgements received as per Q.17 and purchase orders?
32. (a) Are Goods Received Notes and receiving records regularly reviewed for items for which no invoices have been received?
- (b) Are all such items investigated and is provision made for the liability in respect of such items?
- (c) Is such review/investigation done by a person independent of those responsible for the receipt and control of goods?
33. Do all invoices bear evidence of being checked for prices, freight terms, extensions and additions?
34. Is the relative purchase order attached to the invoice for payment?
35. Where the client both buys from and sells to a person regularly, is a periodic review made of all amounts due from that person to determine whether any set-off is necessary?
36. (a) Is a special request used for making payments in advance or

against documents through Bank?

(b) Thereafter, are the invoices processed in the normal course?

37. (a) Are all advance payments duly authorised by persons competent to authorise such payment?

(b) Is a list of pending advances made at least every quarter and is a proper follow-up maintained?

38. Are all adjustments to creditors' accounts duly approved by those authorised in this behalf?

39. Is a list of employees, by designation, with limits of authority in respect of several matters referred to in this section maintained?

40. Are all suppliers' statements compared with ledger accounts?

41. Is there any follow-up action to investigate differences, if any, between the suppliers' statements and the ledger accounts?

42. Is a list of unpaid creditors prepared and reconciled periodically with the General Ledger Control account?

43. Is there a system of ensuring that cash discounts are availed of whenever offered?

Sales and Debtors

1. Are standard price lists maintained?

2. Are prices which are not based on standard price lists, required to be approved by a senior executive outside the Sales Department?

3. Are written orders from customers received in all cases?

4. If oral/telephonic orders are received, are they recorded immediately in the client's standard forms?

5. Is there a numerical control of all customers' orders?

6. Are credit limits fixed in respect of individual customers?

7. Are these limits approved by an official independent of the Sales Department?

8. Are credit limits reviewed periodically?

9. Are customers' credit limits checked before orders are accepted?

10. Is this done by a person independent of the Sales Department?

11. If sales to employees are made at concessional prices:

(a) Is there a limit to the value of such sales?

(b) Is there an adequate procedure to see that these limits are not

exceeded?

(c) Are the amounts recovered in accordance with the terms of sale?

12. Are dispatches of goods authorised only by Dispatch Notes/Gate Passes or similar documents?
13. Do such Dispatch Notes/Gate Passes or similar documents bear preprinted numbers?
14. Are they under numerical control?
15. Are they prepared by a person independent of:
 - (a) the Sales Department?
 - (b) the processing of invoices?
16. Except when all documents are prepared in one operation, are the Dispatch Notes/Gate Passes matched with:
 - (a) Excise Duty records?
 - (b) Sales invoices?
 - (c) Freight payable to carriers (where applicable)
17. Are unmatched Dispatch Notes/Gate Passes reviewed periodically?
18. Are the goods actually dispatched checked independently with the Dispatch Notes/Gate Passes and Customer's Orders?
19. Are acknowledgements obtained from the customers for the goods delivered?
20. Are the customers' orders marked for goods delivered?
21. Are shortages in goods delivered to the customers investigated?
22. Are credits to customers for shortages, breakages and losses in transit match with claims lodged against carriers/insurers?
23. Are sales invoices pre-numbered?
24. Are all invoice numbers accounted for?
25. Are invoices checked for:
 - (a) prices?
 - (b) calculations (including excise duty and sales tax)?
 - (c) terms of payment?
26. Are 'no charge' invoices authorised by a person independent of the custody of goods or cash?
27. Are invoices mailed direct to the customers promptly?

28. Are credits customers for remittances posted only from the entries in the cash book (or equivalent record)?
29. Does cashier notify immediately:
 - (a) Sales Department,
 - (b) Debtors' Ledger Section and
 - (c) Credit Controller:
 - (i) of all dishonoured cheques or other negotiable instruments?
 - (ii) of all documents sent through bank but not returned by the customers?
30. Is immediate follow-up action taken on such notification?
31. Are bills of exchange (or other negotiable instruments) accepted by customers recorded?
32. Are the bills of exchange, etc., as per such record periodically verified with the bills on hand?
33. (a) Is a record of customers' claims maintained?
 - (b) Are such claims properly dealt with in the accounts?
34. Does the Receiving Department count, weigh or measure the goods returned by customers?
35. Does the Receiving Department record them on a Sales Returns Note?
36. Are copies of Sales Returns Notes sent to:
 - (a) Customer?
 - (b) Sales Department?
 - (c) Debtors' Ledger Section?
37. Are the returned goods taken into stock immediately?
38. Is a Credit Note issued to a customer for the goods returned?
39. Are all Credit Notes pre-numbered?
40. Are Credit Notes numerically controlled?
41. Are Credit Notes authorised by a person independent of:
 - (a) Custody of goods?
 - (b) Cash receipts?
 - (c) Debtors' ledger?
42. Are Credit Notes:
 - (a) compared with Sales Returns Notes or other substantiating

evidence?

- (b) checked for prices?
 - (c) checked for calculations?
43. Are corresponding recoveries of sales commissions made when Credit Notes are issued to customers?
 44. Are units of sales (as per sales invoices) correlated and reconciled with the purchases (or production) and stocks on hand?
 45. Is the Sales Ledger balanced periodically and tallied with the General Ledger Control account?
 46. Are ageing schedules prepared periodically?
 47. Are they reviewed by a responsible person?
 48. Are statements of accounts regularly sent to all customers?
 49. Are the statements checked with the Debtors' Ledger before they are issued?
 50. Are the statements mailed by a person independent of the ledger-keeper?
 51. Are confirmations of balances obtained periodically?
 52. Are the confirmations verified by a person independent of the ledger-keeper and the person preparing the statement?
 53. Is special approval required for:
 - (a) Payment of customers' credit balances?
 - (b) Writing off bad debts?
 54. Is any accounting control kept for bad debts written off?
 55. Is any follow-up action taken for recovering amounts written off?
 56. In the case of export sales:
 - (a) is a record maintained of import entitlements due?
 - (b) does the record cover the utilisation/disposal of such entitlements?
 - (c) is there a procedure to ensure that claims for incentives etc., receivable are made in time?
 57. Are sales of scrap and wastage subject to the same procedures and controls as sales of finished goods?

Appendix V

Industries Required to Maintain Cost Records under Section 209(1)(d) of the Companies Act, 1956

<i>Sl. No.</i>	<i>Name of the Industry</i>
1.	Aluminium
2.	Batteries other than Dry Cell Batteries
3.	Bearings
4.	Bulk Drugs
5.	Caustic Soda
6.	Cement
7.	Chemicals
8.	Cosmetic and Toiletries
9.	Cycle
10.	Dry Cell Batteries
11.	Dyes
12.	Electric Cables and Conductors
13.	Electric Fans
14.	Electric Industry
15.	Electric Lamps
16.	Electric Motors
17.	Electronic Products
18.	Engineering Industries
19.	Fertilizer
20.	Footwear
21.	Formulations
22.	Industrial Alcohol
23.	Industrial Gases

24. Insecticides
25. Jute Goods
26. Milk Food
27. Mining and Metallurgy
28. Motor Vehicles
29. Nylon
30. Paper
31. Petroleum Industry
32. Plantation Products
33. Polyester
34. Rayon
35. Refrigerators
36. Room Air Conditioners
37. Shaving Systems
38. Soaps and Detergents
39. Soda Ash
40. Steel Plants
41. Steel Tubes and Pipes
42. Sugar
43. Sulphuric Acid
44. Teecommunications
45. Textlies
46. Tyres and Tubes
47. Vanaspati

Appendix VI

Prudential Norms for Revenue Recognition and Classification of Assets for *Nidhi* and Mutual Benefit Societies

Government of India
Ministry of Law, Justice and Company Affairs
Department of Company Affairs

NOTIFICATION

New Delhi
the 30th April, 2002

GSR 309.....(E) In exercise of the powers conferred by sub-section (1) of section 637 A of the Companies Act, 1956 (1 of 1956), and in supersession of Notification of the Government of India, Ministry of Law, Justice & Company Affairs (Department of Company Affairs) No GSR 556(E) dated 26.7.2001, except as respects things done or omitted to be done before such supersession, the Central Government hereby directs that-

1. Every company declared as a *Nidhi* or Mutual Benefit Society under section 620A of the Companies Act, 1956 (hereinafter referred to as such *Nidhi* or Mutual Benefit Society) after the publication of this Notification shall adhere to the following prudential norms for revenue recognition and classification of assets in respect of mortgage loans or jewel loans, namely:

- (i) income including interest or any other charges on non-performing assets shall be recognised only when it is actually realised. Any such income recognised before the asset became non-performing and remaining unrealised shall be reversed in the current year's profit and loss account;

- (ii) classification of assets

(a) Mortgage Loan:

Nature of Asset	Provision Required
Standard Asset	No provision
Sub-standard Asset	10% of the aggregate outstanding amount
Doubtful Asset	25% of the aggregate outstanding amount
Loss Asset	100% of the aggregate outstanding amount

Explanation: In this direction,-

(1) “Standard Asset” means the asset in respect of which no default in repayment of principal or payment of interest is perceived and which does not disclose any problem nor carry more than normal risk attached to the business;

(2) “Sub-Standard Asset” will be that borrowal account which is a non-performing asset. Reschedulement or Renegotiation or Replacement of the loan instalment or interest payment would not change the classification of assets unless the borrowal account has satisfactorily performed for at least 12 months after such reschedulement or renegotiation or rephasing;

(3) “Doubtful Asset” will be that borrowal account which remained non-performing for more than two years but up to three years;

(4) “Loss Asset” will be that borrowal account which remained non-performing for more than three years or where as per the opinion of the Nidhi or its internal auditor or by the inspecting authority during the course of its inspection a shortfall in the recovery of the loan account is expected because the documents executed may become invalid if subjected to legal process or for any other reason;

(5) “Non-Performing Asset” will be that borrowal account where interest income and/or instalment of loan towards repayment of principal amount remained unrealised for 12 months:

“provided that the *Nidhi* companies or Mutual Benefit Societies incorporated on or before 26.7.2001 shall adhere to the prudential norms as per table given below:

TABLE

Mortgage loans given up to and outstanding as on	Compliance date i.e., date of the balance sheet
(a) 31.3.2000	31.3.2005
(b) 31.3.2001	31.3.2006
(c) 31.3.2002	31.3.2007

- (b) Loans against Jewellery, Government Securities or own deposits, etc.

The aggregate outstanding amount of loan granted against the security of gold, jewellery etc., should be either recovered or renewed within next three months after the due date of repayment specified at the time of grant of such loans. If the loan is not recovered or the security is not sold within the given time, the company should make 100% provision against current year's Profit and Loss Account to the extent of unrealised amount or aggregate outstanding amount of loan as applicable. No income shall be recognised on such loans outstanding after the expiry of three months period or sale of jewellery, whichever is earlier.

2. The above prudential norms for revenue recognition and classification of assets shall be applicable to all Nidhi companies or Mutual Benefit Societies notified under section 620 A of the Companies Act, 1956 before or after the publication of this notification.

3. The Central Government if satisfied that the circumstances have arisen and if found in public interest, after recording the reasons in writing, may relax any of the directions mentioned above either generally or for any specified period, subject to such terms and conditions, as that Government may specify, for avoiding any hardship to any Nidhi or any Mutual Benefit Society or class of Nidhis or class of Mutual Benefit Societies.

(Rajiv Mehrishi)
Joint Secretary

Appendix VII

Specimen Auditor's Report to the Members of the Company

The Members of(name of the Company)²⁴

1. We have audited the attached balance sheet of (name of the company), as at 31st March 2XXX, and also the profit and loss account and the cash flow statement for the year ended on that date annexed thereto. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

2. We conducted our audit in accordance with the auditing standards generally accepted in India. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

3. As required by the Companies (Auditor's Report) Order, 2003 issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Companies Act, 1956, we enclose in the Annexure²⁵ a statement on the matters specified in paragraphs 4 and 5 of the said Order.

4. Further to our comments in the Annexure referred to above, we report that:

(i) We have obtained all the information and explanations, which to the best of our knowledge and belief were necessary for the purposes of our audit;

(ii) In our opinion, proper books of account as required by law have been kept by the company so far as appears from our examination of those books (and proper returns adequate for the purposes of our audit have been

²⁴ Reference may also be made to the Auditing and Assurance Standard (AAS) 28, The Auditor's Report on Financial Statements, Statement on Qualifications in Auditor's Report and the Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956 issued by the Institute of Chartered Accountants of India.

²⁵ Alternatively, instead of giving the comments on Companies (Auditor's Report) Order, 2003 in an Annexure, the comments may be contained in the body of the main report.

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received from the branches not visited by us. The Branch Auditor's Report(s) have been forwarded to us and have been appropriately dealt with)²⁶;

(iii) The balance sheet, profit and loss account and cash flow statement dealt with by this report are in agreement with the books of account (and with the audited returns from the branches)²⁷;

(iv) In our opinion, the balance sheet, profit and loss account and cash flow statement dealt with by this report comply with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956;

(v) On the basis of written representations received from the directors, as on 31st March 2XXX and taken on record by the Board of Directors, we report that none of the directors is disqualified as on 31st March 2XXX from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956;

(vi) In our opinion and to the best of our information and according to the explanations given to us, the said accounts give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:

- (a) in the case of the balance sheet, of the state of affairs of the company as at 31st March 2XXX;
- (b) in the case of the profit and loss account, of the profit / loss¹⁶ for the year ended on that date; and
- (c) in the case of the cash flow statement, of the cash flows for the year ended on that date. .

For ABC and Co.
Chartered Accountants

Signature
(Name of the Member Signing the Audit Report)
(Designation¹⁷)
Membership Number

Place of Signature
Date

²⁶ Wherever applicable.

²⁷ Wherever applicable.

¹⁶ Whichever is applicable.

¹⁷ Partner or Proprietor, as the case may be.

Annexure

Re:.....Limited

Referred to in paragraph 3 of our report of even date,

1. The company has maintained proper records showing full particulars including quantitative details and situation of fixed assets.
2. All the assets have not been physically verified by the management during the year but there is a regular programme of verification which, in our opinion, is reasonable having regard to the size of the company and the nature of its assets. No material discrepancies were noticed on such verification.
3. During the year, the company has disposed off a major part of the plant and machinery. Based on the information and explanation given by the management and on the basis of audit procedures performed by us, we are of the opinion that the sale of the said part of plant and machinery has not affected the going concern.
4. The inventory has been physically verified during the year by the management. In our opinion, the frequency of verification is reasonable.
5. The procedures of physical verification of inventories followed by the management are reasonable and adequate in relation to the size of the company and the nature of its business.
6. On the basis of our examination of the records of inventory, we are of the opinion that the company is maintaining proper records of inventory. The discrepancies noticed on verification between the physical stocks and the book records were not material.
7. The following are the particulars of loans taken by the company from companies, firms and other parties covered in the Register maintained under Section 301 of the Companies Act, 1956:

<i>Sl. No.</i>	<i>Name of Party</i>	<i>Relationship with Company</i>	<i>Amount Rs.</i>	<i>Year end Balance Rs.</i>
1.	XYZ Enterprises	Firm in which directors are interested	10,00,00	NIL
2.	ABC Limited	Subsidiary	50,00,000	10,00,000

8. The following are the particulars of loans granted by the company to companies, firms and other parties covered in the register maintained under section 301 of the Companies Act, 1956:

Sl. No.	Name of Party	Relationship with Company	Amount Rs.	Year end Balance Rs.
1.	PQR Ltd.	Associate	40,00,000	NIL

9. In our opinion the rate of interest and other terms and conditions on which loans have been taken from/granted to companies, firms or other parties listed in the registers maintained under Section 301 are not, *prima facie*, prejudicial to the interest of the company.
10. The company is regular in repaying the principal amounts as stipulated and has been regular in the payment of Interest. The parties have repaid the principal amounts as stipulated and have been regular in the payment of interest.
11. There is no overdue amount of loans taken from or granted to companies, firms or other parties listed in the registers maintained under section 301 of the Companies Act, 1956.
12. In our opinion and according to the information and explanations given to us, there are adequate internal control procedures commensurate with the size of the company and the nature of its business with regard to purchases of inventory, fixed assets and with regard to the sale of goods. During the course of our audit, no major weakness has been noticed in the internal controls.
13. Based on the audit procedures applied by us and according to the information and explanations provided by the management, we are of the opinion that the transactions that need to be entered into the register maintained under section 301 have been so entered.
14. In our opinion and according to the information and explanations given to us, the transactions made in pursuance of contracts or arrangements entered in the registers maintained under Section 301 and exceeding the value of five lakh rupees in respect of any party during the year have been made at prices which are reasonable having regard to prevailing market prices at the relevant time.
15. In our opinion and according to the information and explanations given to us, the company has complied with the provisions of Sections 58A and 58AA of the Companies Act, 1956 and the Companies (Acceptance of Deposits) Rules, 1975 with regard to the deposits accepted from the public. No order has been passed by the National Company Law Tribunal.

16. In our opinion, the company has an internal audit system commensurate with the size and nature of its business.
17. We have broadly reviewed the books of account relating too materials, labour and other items of cost maintained by the company pursuant to the Rules made by the Central Government for the maintenance of cost records under Section 209 (1) (d) of the Companies Act, 1956 and we are of the opinion that *prima facie* the prescribed accounts and records have been made and maintained.
18. According to the records of the company, the company is regular in depositing with appropriate authorities undisputed statutory dues including provident fund, investor education protection fund, employees' state insurance, income-tax, sales-tax, wealth-tax, custom duty, excised-duty, cess and other statutory dues applicable to it.
19. According to the information and explanations given to us, no undisputed amounts payable in respect of income tax, wealth tax, sales tax, customs duty and excise duty were outstanding, as at..... for a period of more than six months from the date they became payable.
20. According to the records of the company, there are no dues of sale tax, income-tax, customs tax/wealth-tax, excise duty/cess which have not been deposited on account of any dispute.
21. The accumulated losses of the company are not more than fifty percent of its net worth. The company has not incurred any cash losses during the financial year covered by our audit and the immediately preceding financial year.
22. Based on our audit procedures and on the information and explanations given by the management, we are of the opinion that the company has not defaulted in repayment of dues to a financial institution, bank or debenture holders.
23. Based on our examination of documents and records, we are of the opinion that the company has maintained adequate records where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities.
24. Based on our examination of the records and evaluation of the related internal controls, we are of the opinion that proper records have been maintained of the transaction and contracts and timely entries have been made in those records. We also report that the company has held the shares, securities, debentures and other securities in its own name.
25. The company has not given any guarantee for loans taken by others

from bank or financial institutions.

26. The term loans have been applied for the purpose for which they were raised.
27. Based on our examination of the balance sheet of the company as at _____ (*the date of previous financial statements*), we find that the company as on that date had long-term sources of funds amounting to Rs. 150,000/-. The long-term application of funds was Rs. 190,000/-. Because of non-availability of adequate information for the purpose of identification of funds raised with a particular asset, we are unable to comment the sources from which Rs. 40,000/- (excess of long-term application of funds over the long-term sources of funds) have been applied. During the accounting period covered by our report, the company generated Rs. 90,000/- long-term sources and applied Rs. 70,000/- towards long-term applications. Rs. 20,000/- of the funds raised from long-term sources during the accounting period covered by our report were used for short-term applications.
28. The company has made preferential allotment of shares to parties and companies covered in the register maintained under section 301 of the Act. In our opinion the price at which shares have been issued is not prejudicial to the interest of the company.
29. During the period covered by our audit report, the company has issued 1,00,000 debentures of Rs. 100 each. The company has not created any security in respect of debentures issued.
30. The end use of money raised by public issues as disclosed in the financial statements has been verified by us.
31. Based upon the audit procedures performed and information and explanations given by the management, we report that no fraud on or by the company has been noticed or reported during the course of our audit.

For ABC and Co.,
Chartered Accountants

Signature
(*Name of the Member Signing the Audit Report*)
(*Designation*¹⁷)
Membership Number

Place of Signature
Date

¹⁷ Partner or Proprietor, as the case may be.