

Audit Report

Question 1

H.W.P. Private Ltd. is having only two members H and W. During the audit of accounts for the year ended 31st March, 2010, you as auditor find that:

- (i) *H, who is incharge of purchases has introduced fictitious purchase bills of ₹ 50 lakhs.*
- (ii) *W, who is incharge of sales has sold goods worth ₹ 1 crore without bringing the same in the books of account.*

You raise the matter with H and W in their capacity as directors. They contest that as this is a position known to them and within their own fold, you should not report the same under the Companies Act, 1956.

Discuss whether the above arguments are acceptable under the Companies Act, 1956 for non-reporting. If not, state the reasons and the manner of reporting.

Answer

The arguments put forth by H and W, directors of H.W.P. Pvt. Ltd., for non-reporting of fictitious purchases of ₹ 50 lakhs and omission of recording of sales of ₹ 1 crore under the Companies Act, 1956 are not acceptable in view of the following reasons:

- (i) The scope of audit of a company is determined by provisions of the Companies Act, 1956. Even the terms of the engagement cannot restrict the scope of audit in relation to matters which are prescribed by legislation. Corresponding to scope of audit, even the rights of an auditor available under statute cannot be restricted. In the case of *Newton v. Birmingham Small Arms Co. (1895)*, it was held that any regulation which precludes the auditors from availing themselves of all the information to which they are entitled under the Companies Act are inconsistent with the Act.
- (ii) Section 227(2) provides that the duty of an auditor is to make a report to the members of the company. In his report, the auditor has to state whether “in his opinion and to the best of his information and according to the explanations given to him”, the accounts “give a true and fair view in the case of the balance sheet, of the state of the company’s affairs as at the end of its financial year and in the case of the profit and loss account, of the profit or loss for its financial year”. Thus, the primary duty of the auditor is to determine whether the balance sheet shows a true and fair view of the state of the company’s affairs as at the end of the financial year and whether the profit and loss account shows a true and fair view of the working results of the company for the year.

- (iii) The Companies Act, 1956 does not make any distinction between a private limited company and a public limited company. Therefore, the fact that there are only two members and they are fully aware of such transactions would not have any impact as far as scope of audit is concerned. The decision in *Pendleburys Ltd. vs. Ellis Green and Co.* (1936) holding the auditors not liable for not reporting separately to the shareholders as the report had been given to the directors who are the sole shareholders, will not hold good at present.

Therefore, in view of the above mentioned reasons, inflation of purchases (which in this case is of ₹ 50 lakhs) and omission of sales (which in this case is of ₹ 1 crore) is bound to affect the true and fair view of the financial statements of the company. It would, therefore, be obligatory on the part of auditor to report these aspects in the audit report.

The following paragraph in the audit report under section 227 of the Companies Act, 1956 should be included:

"The purchases of ₹ as reflected in the profit and loss account are overstated by ₹ 50 lakhs and sales of ₹as reflected in the Profit and Loss Account are understated by ₹ 1 crore. This has had the effect of understating the profits of the company by ₹ 1.50 crores. On account of these discrepancies, the current liabilities are overstated by ₹ 50 lakhs, the current assets are understated by ₹ 1 crore and reserves are understated (before tax) by ₹ 1.50 crores."

Subject to the above, in our opinion and to the best of our information, the accounts do not portray a true and fair view.

Notes:

- (i) Having regard to materiality aspects, the auditor may qualify the audit report instead of an adverse report which would involve usage of words "subject to the above" as a prefix to qualification paragraph followed by the statement that the accounts show a true and fair view.
- (ii) The action of H and W in inflating purchases and deflating sales may have effect on the stock positions reflected in the stock ledgers and on the physical inventory. If it be so, it may also be essential to include appropriate remarks in the report required to be issued CARO, 2003

Question 2

Discuss the reporting requirements under the Companies (Auditor's report) Order, 2003 where a company has defaulted in compliance of Section 58AA of the Companies Act, 1956 with regard to public deposits.

Answer

Under paragraph 4(vi) of Companies (Auditor's) Report Order 2003 the audit report should include following matters:

In case company has accepted any deposits from public whether directives issued by the Reserve Bank of India and the provisions of sections 58 A and 58 AA or any other relevant provisions of the Act and the rules framed there under, where ever applicable, have been complied with. If not the nature of contraventions should be stated. If an order has been passed by Company Law Board or National Law Tribunal or Reserve Bank of India or any court or any other tribunal whether the same has been complied with or not ?

Section 58 AA deals with small depositors. As per this, a small depositor means a depositor who has deposited during a financial year a sum not exceeding rupees twenty thousand. This section requires compliance of certain matters by the company.

Non compliance of section 58 AA occurs where company fails to intimate company law board, any default in repayment of deposit by small depositors or part there of or any interest thereupon. The auditor has therefore, to first determine whether there is any default in repayment of such deposits, when number of depositors are large, it may not be possible for an auditor to verify each repayment. In such situation, he should examine internal control system. He should obtain schedule of repayment to small depositors, and should make reasonable test checks of repayments made by the company. If during test check, default in repayment is noticed, he should see whether the same has been intimated to Company Law Board.

Over and above this, auditor should also examine regarding non compliance of Section 58 AA or rules made there under he should enquire, about any order passed by any of the relevant authorities for contravention of section 58 AA

The auditor should obtain management representation to the effect whether:

- (i) Company has complied with directives issued by Reserve Bank of India and provision of Section 58 AA or relevant rules. and
- (ii) Where an order has been passed by any of the relevant authorities, the company has complied with requirements of the order

Question 3

The Statutory auditors of Get well Ltd. included certain comments in his report u/s 227 of the Companies Act, 1956. Since the company requested the auditors to drop the above comments, as otherwise it will affect their future business, as a compromise the auditor included the comment in the report in ordinary type. Comment.

Answer

As per Section 227(3) (e) of the Companies Act, 1956, one of the issues relating to audit report is that the report shall indicate in Bold or in Italics the observations as comments of the auditor which have any adverse effect on the functioning of the company. According to the Guidance Note issued clause (e) of the sub-section creates a requirement for the auditor to consider any matter leading to the modification of the auditor report on financial statements is

likely to have an adverse effect on the functioning of the company and if so the auditor is required to highlight such matter in Bold or in Italics.

In the instant case, the auditor's action in having printed certain comments in ordinary type is contrary to the provision of the Act and Guidance Note. He will be deemed to have discharged his duties negligently.

Question 4

As the auditor of PQRS Ltd what steps would you take to comply with the requirement of Companies (Auditors Report) Order, 2003 in respect of the following cases?

- (i) *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, Customs duty, Excise duty, Cess and any other statutory dues with the appropriate authorities and if not, the extent of 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.*
- (ii) *Whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than fifty percent of its net worth and whether it has incurred cash losses in such financial year and in the immediately preceding financial year.*

Answer

- (i)
 - 1. The auditor has to report upon regularity of the company in depositing undisputed statutory dues.
 - 2. If the company is not regular in depositing the undisputed statutory dues the auditor has to state the extent of arrears of statutory dues which have remained outstanding as at the last day of the financial year.
 - 3. The payment includes all other statutory dues payable by the company.
 - 4. The amount payable will include the interest/penalty payable under the respective laws.
 - 5. The auditor has to get a written representation from the management indicating the details of disputed claims, undisputed but have remained outstanding for more than six months and a statement as to the completeness of the information provided by the management.
- (ii)
 - 1. This clause is applicable to all the companies which are in existence for more than five years.
 - 2. The auditor has to report (i) whether the accumulated losses at the end of the financial year are more than 50% of its net worth and (ii) whether the company has incurred cash losses during the period covered by the report and in the immediate previous year.

3. The term loss should be construed to mean the net profit/loss shown by the P & L a/c of the company as adjusted after taking into account qualifications in the audit report to the extent qualifications are quantified.
4. Net worth is defined as sum of total paid up capital and free reserves after deducting the provisions or expenses as may be prescribed.
5. Free reserve means all reserves created out of profits and share premium but does not include reserves created out of revaluation of assets, write back of depreciation provisions and amalgamation.
6. The auditor has to indicate his opinion on the above and the effect of qualifications.

Question 5

The audit report of P Ltd. for the year 2008-09 contained a qualification regarding non-provision of doubtful debts. As the statutory auditor of the company for the year 2009-10, how would you report, if:

- (i) *The company does not make provision for doubtful debts in 2008-09?*
- (ii) *The company makes adequate provision for doubtful debts in 2008-09?*

Answer

Auditor's responsibilities in cases where audit report for an earlier year is qualified is given in SA 710 "Comparative Information – Corresponding Figures and Comparative Financial Statements". As per SA 710, When the auditor's report on the prior period, as previously issued, included a qualified opinion, a disclaimer of opinion, or an adverse opinion and the matter which gave rise to the modified opinion is resolved and properly accounted for or disclosed in the financial statements in accordance with the applicable financial reporting framework, the auditor's opinion on the current period need not refer to the previous modification.

SA 710 further states that if the auditor's report on the prior period, as previously issued, included a qualified opinion and the matter which gave rise to the modification is unresolved, the auditor shall modify the auditor's opinion on the current period's financial statements. In the Basis for Modification paragraph in the auditor's report, the auditor shall either:

- (a) Refer to both the current period's figures and the corresponding figures in the description of the matter giving rise to the modification when the effects or possible effects of the matter on the current period's figures are material; or
- (b) In other cases, explain that the audit opinion has been modified because of the effects or possible effects of the unresolved matter on the comparability of the current period's figures and the corresponding figures.

In the instant Case, if P Ltd. does not make provision for doubtful debts the auditor will have to modify his report for both current and previous year's figures as mentioned above. If however, the provision is made, the auditor need not refer to the earlier year's modification.

Question 6

X Ltd. did not follow the applicable Accounting Standard for disclosing Earnings Per Share (EPS) in the financial statements. The fact of such non-disclosure was however, mentioned in the notes forming part of accounts. As the statutory auditor of X Ltd., how would you report in the above case?

Answer

Disclosure of EPS is required for all companies as per AS 20 "Earnings per Share". AS 20 is also one of the AS notified by the Companies (Accounting Standards) Rules, 2006. If the disclosures required by AS 20 are not made, it is the duty of the auditor to qualify in his report "Whether Accounting Standards under the clause as notified u/s 211(3C) have been followed?" Mere disclosure by company in notes does not absolve him of his duty.

The same is however not a qualification to affect the "True & Fair" position of financial results of the company.

Question 7

Is the auditor of a company supposed to refer any paragraph in Director's report in his own report to the shareholders of the company? State your views in this regard.

Answer

Section 217 of the Companies Act, 1956 specifies the contents to be included in the Board of Directors' report and states that there shall be attached to every balance sheet laid before a company in general meeting, a report by its Board of Directors, with respect to:

- (i) the state of the company's affairs;
- (ii) the amounts, if any, which it proposes to carry to any reserves in such balance sheet;
- (iii) the amount, if any, which it recommends should be paid by way of dividend;
- (iv) material changes and commitments, if any, affecting the financial position of the company which have occurred between the end of the financial year of the company to which the balance sheet relates and the date of the report;
- (v) conservation of energy, technology absorption, foreign exchange earnings and outgo, in such manner as may be prescribed.

The Board's report shall also contain the material aspects relating to appreciation of the state of company's affairs and deal with important changes. The Board shall also be bound to give the fullest information and explanation in its report aforesaid, or in case falling under the proviso to Section 222, in an addendum to that report, on every reservation, qualification or adverse remark in the auditors' report.

Section 227 of the Act states that it is the duty of an auditor to make a report to the members of the company on the accounts examined by him on every balance sheet and profit and loss account, and every other document declared by this Act to be part of annexed to the balance

sheet or profit or loss account which are laid before the company in general meeting during his tenure of office. Thus, as per section 227, the auditor is required to report only on those documents which are part of or annexed to the Balance Sheet and Profit and Loss Account. The subject matter of the auditor's report is the books of account and the financial statements including notes thereon and any other documents annexed thereto and not the Board's Report which as per section 217 is attached to balance sheet.

Section 222 of the Act dealing with construction of reference to documents annexed to accounts also makes it clear that Board's report is attached to the annual accounts. Therefore, normally the auditors' report does not cover authentication of various matters contained in the Board's report. This is despite the fact that the Board's report contains many matters as stated above, having a bearing on accounts and financial position of the company. For example, the amount of proposed dividend, amount of depreciation, the net profit before tax and net profit after tax are common items that are contained in the Board's report.

However, proviso to section 222 requires that if any information which is required by this Act to be given in the accounts, and is allowed by it to be given in a statement annexed to the accounts, may be given in the Board's report instead of in the accounts; and if any such information is so given, the report shall be annexed to the accounts and this Act shall apply in relation thereto accordingly, except that the auditors shall report thereon only in so far as it gives the said information.

Question 8

As an auditor, state your view on the following:

The Statutory Auditors of a Government Company have issued a qualified Audit Report on the accounts of the company. In his supplementary audit, the Comptroller and Auditor General of India (C and AG) has also made further qualifications on the accounts of the company.

But the report of the Board of Directors of the Company is silent on the comments of statutory auditors and those of C and AG.

Answer

Board's Report and Qualifications in the Auditor's Report: Section 217(3) of the Companies Act, 1956 imposes a duty on the Board of directors of a company to give the fullest information and explanations in the Directors' report regarding every reservation, qualification or adverse remarks contained in the auditor's report. The remarks of the Board on the auditor's report are to be given as addendum to the report and are to form part of the main body of the report as per section 217(3). Hence there is failure on the part of the Board of directors in not having offered its explanation on the reservations, qualifications or adverse remarks made in the auditor's report.

However in the absence of similar provisions in section 217(3) of the Companies Act, 1956 requiring the company to give their reply on the reservations, qualifications etc. contained in the supplementary audit report made by the C&AG, the Board of Directors of such a company is not bound to give information or explanation in respect of such comments. Therefore, in the

absence of any legal provision, the Board, has not committed any default by not giving any explanation on comment of the C&AG.

Question 9

Write short notes on the following:

- (a) *Audit Certificate as distinguished from Audit Report*
- (b) *Disclosure under "Basis of Issue Price" in prospectus.*

Answer

(a) **Audit Certificate as distinguished from Audit Report:** A certificate is a written confirmation of the accuracy of the facts stated therein and does not involve any estimate or opinion. The term 'certificate' is, therefore, used where the auditor verifies the accuracy of facts. An auditor may thus, certify the circulation figures of a newspaper or the value of imports or exports of a company. An auditor's certificate represents that he has verified certain figures and is in a position to vouchsafe their accuracy as per his examination of documents and books of account. A report, on the other hand, is a formal statement usually made after an enquiry, examination or review of specified matters under report and includes the reporting auditor's opinion thereon. Thus, when a reporting auditor issues a certificate, he is responsible for the factual accuracy of what is stated therein. On the other hand, when a reporting auditor gives a report, he is responsible for ensuring that the report is based on factual data, that his opinion is in due accordance with facts, and that it is arrived at by the application of due care and skill. The 'report' involves expression of opinion which may differ from one professional to another. There is no question of exactitude in case of a report since the information contained therein is based on estimates and involves judgement element.

(b) **Disclosures under 'Basis of Issue Price':** Under this heading, the following information is to be disclosed:

1.
 - (a) Earnings per share, i.e., EPS pre-issue for the last three years (as adjusted for changes in capital);
 - (b) P/E pre-issue and comparison thereof with industry P/E where available (giving the source from which industry P/E has been taken);
 - (c) Average return on net worth in the last three years;
 - (d) Minimum return on the increased net worth required to maintain pre-issue EPS;
 - (e) Net Asset Value per share based on last balance sheet;
 - (f) Net Asset Value per share after issue and comparison thereof with the issue price.

Provided that projective earnings shall not be used as a justification for the issue price in the offer document.

2. The accounting ratios disclosed in the offer document in support of basis of the issue price shall be calculated after giving effect to the consequent increase of capital on account of compulsory conversions outstanding, as well as on the assumption that the options outstanding, if any, to subscribe for additional capital will be exercised.

Question 10

What are the contents of reports and certificates for special purposes?

Answer

Contents of Reports and Certificates for Special Purposes: The contents of reports and certificates for special purposes in many cases are specified by statute and cannot be changed. However, in cases where no format has been specified, the reporting auditor can choose the form and contents. In such cases, where a reporting auditor is free to draft his report or certificate, he should consider the following:

1. Specific elements, accounts or items covered by the report or certificate should be clearly identified and indicated.
2. The report or certificate should indicate the manner in which the audit was conducted, e.g., by the application of generally accepted auditing practices, or any other specific tests.
3. If the report or certificate is subject to any limitations in scope, such limitations should be clearly mentioned.
4. Assumptions on which the special purpose statement is based should be clearly indicated if they are fundamental to the appreciation of the statement.
5. Reference to the information and explanations obtained should be included in the report or certificate. In certain cases apart from a general reference to information and explanations obtained, a reporting auditor may also find it necessary to refer in his report or certificate to specific information or explanations on which he has relied.
6. The title of the report or certificate should clearly indicate its nature, i.e., whether it is a report or a certificate. Similarly, the language should be unambiguous, i.e., it should clearly bring out whether the reporting auditor is expressing an opinion (as in the case of a report) or whether he is only confirming the accuracy of certain facts (as in the case of a certificate). For this, the choice of appropriate words and phrases is important.
7. If the special purpose statement is based on general purpose financial statements, the report or certificate should contain a reference to such statements. However, the report or certificate should not contain a reference to any other statement unless the same is attached therewith. It should be clearly indicated whether or not the statutory audit of the general purpose financial statements has been completed and also, whether such audit has been conducted by the reporting auditor or by another auditor. In case the general purpose financial statements have been audited by another auditor, the reporting auditor

should specify the extent to which he has relied on them. He may communicate with the statutory auditor for securing his cooperation and in appropriate circumstances, discuss relevant matters with him, if possible.

8. Where a report requires the interpretation of a statute, the reporting auditor should clearly indicate the fact that he is merely expressing his opinion in the matter. He should take sufficient care to ensure that in respect of matters which are capable of more than one interpretation, his report is not misconstrued as representing a settled legal position.
9. An audit report or certificate should ordinarily be a self-contained document. It should not confine itself to a mere reference to another report or certificate issued by the reporting auditor but should include all relevant information contained in such report or certificate.
10. The reporting auditor should clearly indicate in his report or certificate, the extent of responsibility which he assumes. Where the statement on which he is required to give his report or certificate, includes some information which has not been audited, he should clearly indicate in his report or certificate the particulars of such information.

In certain cases, the form and/or contents of the report or certificate, as prescribed by a statute or a notification, may not be appropriate or adequate. In such situations, the reporting auditor may consider modifying the report or certificate on the basis of the aforesaid parameters, to the extent applicable. In case this is not possible, he should clearly indicate the limitations in his report or certificate itself.

Question 11

What is your understanding of the term "true and fair view" in a statutory audit report of a company?

Answer

Meaning of Expression "True and Fair View": The requirements of the Companies Act, 1956 are that the auditor should specifically express an opinion whether the published accounts give a true and fair view of the company's state of affairs and of the profit and loss for the financial year. What constitutes a 'true and fair view' has not been defined in the Act. Sub-sections (1) and (2) of section 211 merely require that every balance sheet and profit and loss account of a company shall give a true and fair view of the state of affairs and profit or loss of the company and shall comply with the requirements of Revised Schedule VI to the Companies Act, 1956 so far as they are applicable. Sub-section (5) of this section implies that the balance sheet and the profit and loss account of a company shall be deemed as not showing a true and fair view, if they do not disclose any matters which are required to be disclosed by virtue of the provisions of Revised Schedule VI or by virtue of a notification or an order of the central government modifying the disclosure requirements. It is clear that the auditor will have to examine whether the financial statements are drawn up in conformity with the provisions of Revised Schedule VI and whether they contain the matters required to be disclosed therein. Thus, one of the tests for determining whether or not the financial statements show a true and fair view is to check whether all relevant disclosures as required by the governing Act have been properly made.

The phrase 'true and fair' in the auditor's report signifies that the auditor gives an opinion as to whether the financial statements represent fairly the actual financial position as at the end of the accounting period and profit or loss for that period. "SA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with Standards on Auditing" states that, "in forming his opinion on the financial statements, the auditor follows procedures designed to satisfy himself that the financial statements reflect a true and fair view of the financial position and operating results of the enterprise. The auditor recognises that because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any system of internal control, there is an unavoidable risk that some material misstatement may remain undiscovered. While in many situations the discovery of a material misstatement by management may often arise during the conduct of the audit, such discovery is not the main objective of audit nor is the auditor's programme of work specifically designed for such discovery. The audit cannot, therefore, be relied upon to ensure the discovery of all frauds or errors but where the auditor has any indication that some fraud or error may have occurred which could result in material misstatement, the auditor should extend his procedures to confirm or dispel his suspicions." What constitutes a true and fair view is, thus, a matter of an auditor's judgement in the particular circumstances of a case. However, the following general guidelines may be laid down in this regard.

1. The balance sheet and the profit and loss account should be drawn up in conformity with the requirements of the Companies Act or those of the specific Acts governing certain classes of companies.
2. Relevant information should be so disclosed in the balance sheet and the profit and loss account that the financial position and the working results are shown as they are, i.e. there is neither an overstatement nor an understatement. There should be no window-dressing; the balance sheet and the profit and loss account should not attempt to show a better picture than what it is in reality. Similarly, there should be no secret reserves (unless the statute specifically permits the creation of such reserves).
3. All material facts regarding expenses, revenues, assets and liabilities of the company should be disclosed. There should be no misstatement.
4. All unusual, exceptional, or non-recurring items should be disclosed separately.
5. The balance sheet and the profit and loss account should be prepared and presented in conformity with the generally accepted principles of accounting. Such principles should be consistently applied. The effect of a change in these principles should be suitably disclosed.
6. The auditor should examine the situation as it exists at the end of the accounting period. If certain subsequent events help the auditor in making a better assessment of the position as at the date of the balance sheet, the auditor should take such events into account.

8.12 Advanced Auditing and Professional Ethics

7. The financial statements should convey the required information clearly. As has been held in many legal cases, information and means of information are by no means equivalent terms. A person whose duty it is to convey information to others does not discharge that duty by simply giving them so much of information as is calculated to induce them, or some of them, to ask for more.

Question 12

Write a short note on - Reporting on the compilation engagement.

Answer

SA 4410 "Engagements to Compile Financial Information": The objective of a compilation engagement is to use accounting expertise, as opposed to auditing expertise, to collect, classify and summarise financial information. This ordinarily entails reducing detailed data to a manageable and understandable form without the requirement to test the assertions underlying that information. The procedures employed are not designed and do not enable the member to express any opinion on the financial information. Therefore, it is essential that the member clearly brings out the nature of association with the financial statement and the nature of the work performed by him. The following may be noted in this regard.

1. The title of the report should be "Accountant's Report on Unaudited Financial Statement and not An Auditor's Report".
2. The report should be addressed to the appointing authority.
3. The report should identify the financial information compiled, also stating that it is based on the information provided by the management.
4. The report should clearly state that the financial statements are not audited.
5. In describing the engagement, ambiguous terms such as review, general review, check, etc. should not be based.
6. Date of the report should be mentioned.
7. Name and address of the firm of the member appointed for carrying out the compilation engagement should be mentioned.
8. Signature and the designation (sole proprietor/ partner) and membership number should appear in the report.

Question 13

As Chartered Accountant you are required to give your reports on various financial statements under Companies Act, 1956 which are as under:

- (i) *Report to the shareholders under Section 227;*
- (ii) *Report to be set out in prospectus under Section 60(3);*
- (iii) *Report to be given to the Central Government as special auditor under Section 233A;*

(iv) *Report to be given on voluntary winding up under Section 488(1).*

Explain the significance of each of these reports and your functional approach very briefly.

Answer

Auditor's report on the Companies Act, 1956 (the Act)

- (i) **Report to Shareholders U/s 227:** Section 227 of the Act lays down powers and duties of the auditor. Sub-sections (2), (3), (4) and (4A) of Section 227 deal with reporting requirements. Sub-section (2) states that the auditor of a company shall make a report to the members on the accounts examined by him and on every balance sheet and profit and loss account which are laid before company in general meeting during the tenure of his office. The significance of the report lies in the fact that it requires that the report shall state whether in his opinion and to the best of his information and according to the explanations given to him the said accounts give the information required by the Act in the manner so required and give a true and fair view.

The functional approach by the auditor for making a report u/s 227 of the Act, requires him to perform compliance and substantive audit procedures to verify the information contained in the financial statements. Having regard to the materiality of the items involved, the auditor also determines whether the relevant information is properly disclosed in the financial statements.

- (ii) **Report to be set out in the prospectus u/s 60(3):** Section 60(3) of the Act provides that a prospectus should be accompanied *inter alia* by the consent in writing of the person named therein as the auditor of the company or intended company, to act in that capacity. Part II of Schedule II to the Act prescribes the reports to be set out in a prospectus. The report contains particulars about profit and losses of the company for five preceding year, assets and liabilities, rates of dividend, etc. The significance of the report lies in the fact that a prospectus is issued by a company when it seeks to raise funds from the public and gives detailed information about the company to enable prospective investors to take a well-informed decision. The functional approach on the part of auditor involves obtaining information from the management, particularly, in respect of estimation of current and future profits. He has to also ensure that all adjustments have been made properly.
- (iii) **Special Audit Report U/s 233A:** Under section 233A of the Act, the Central Government has a power to order a special audit of the accounts of a company for a specified period. An order to conduct special audit of the accounts of a company may be made where the Central Government is of the opinion that:
- (a) the affairs of the company are not being managed in accordance with sound business principles or prudent commercial practices; or
 - (b) the company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or
 - (c) the financial position of the company is such as to endanger its solvency.

The main objective of such an audit is to provide a critical review of the company's working and state of affairs to the government. Special audit should be distinguished from 'investigation' into the affairs of a company under section 235 of the Act. The special auditor has the same powers and duties which a company auditor has under section 227 of the Act, with the difference, however, the instead of making his report to the members of the company, the special auditor makes the report to the central government. The special audit report should, as far as possible, include all the information required to be included in an audit report under section 227 of the Act. However, the central government may direct that the special audit report shall also include a statement on any other matter referred to the special auditor by the government.

- (iv) Report on the accounts prepared on voluntarily winding up u/s 488 (1): Section 488(1) of the Act requires that where it is proposed to wind up a company voluntarily, its directors, or in case the company has more than two directors, the majority of the directors, may at a meeting of the Board, make a declaration verified by an affidavit, to the effect that they have made a full inquiry into the affairs of the company, and that, having done so, they have formed the opinion that the company has no debts, or that it will be able to pay its debts in full within such period not exceeding three years from the commencement of the winding up as may be specified in the declaration. Such declaration has to be accompanied by a copy of the report of the auditors of the company (prepared, as far as circumstances admit, in accordance with the provisions of this Act) on the profit and loss account of the company for the period commencing from the date up to which the last such account was prepared and ending with the latest practicable date immediately before the making of the declaration and the balance sheet of the company made out as on the last mentioned date and also embodies a statement of the company's assets and liabilities as at the date.

Question 14

- (a) *A Pvt. Ltd. is incorporated on 1st July, 2009. During the year ended 31st March, 2010, it had issued shares (fully paid up) of ₹ 40 lakhs, had borrowed ₹ 7.5 lakhs each from 2 financial institutions and its turnover (Net of excise ₹ 50 lakhs which is credited to a separate account) is ₹ 475 lakhs. Will Companies Auditors Report Order, 2003 (CARO) be applicable to A Pvt. Ltd.?*
- (b) *As the statutory auditor of B Ltd. to whom CARO, 2003 is applicable, how would you report in the following situations?*
- (i) *The company has stood guarantee to its sister concern, whose financial condition was not healthy for a sum of ₹ 20 lakhs borrowed from a bank.*
- (ii) *Physical verification of only 50% (in value) of items of inventory has been conducted by the company. The balance 50% will be conducted in next year due to lack of time and resources.*

- (iii) *Accumulated losses of the company are 50.9% of its net worth and it is incurring continuous cash losses since last 2 years.*

Answer

- (a) The Companies (Auditor's Report) Order (CARO), 2003, exempts private limited companies from its application which fulfils all the following conditions:

- (i) its paid-up capital and reserves are rupees fifty lakh or less;
- (ii) its outstanding loan from any bank or financial institution are rupees twenty five lakh or less; and
- (iii) its turnover does not exceed rupees five crore.

In the case of M/s A Pvt. Ltd., its paid-up capital is less than ₹ 50 lakhs, turnover is less than ₹ 5 crores since excise duty is not taken into account if it is credited separately to excise duty account; and, it is also implied from the facts that it has not accepted any public deposits. It also fulfils the condition relating to outstanding loan as per the statement on CARO, 2003, issued by the Institute Hence, M/s A Pvt. Ltd. satisfies all conditions and accordingly CARO, 2003 will not be applicable.

- (b) (i) Para 4(xv) of CARO, 2003 requires the auditor to state in his report whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and condition whereof are prejudicial to the interests of the company. The auditor should examine the Memorandum of Association to determine whether the company has the power to give guarantee. The auditor should also examine the minute book and register of guarantee to ascertain whether guarantee has been issued under the sanction of competent authority. The auditor should also verify compliance with requirements of sections 295 and 372A of the Companies Act, 1956. It should also be ensured that the guarantee given is shown as contingent liability.

In determining whether the guarantee is prejudicial to the interest of the company, the auditor should consider financial standing of the party, nature of security offered, etc. In this case, since financial condition of the company on behalf of whom guarantee is given is not so good, the auditor may consider expressing an opinion that the terms and conditions on which the company has given guarantees for loans taken by the sister concern, i.e., M/s B Ltd., is prejudicial to the interests of the company.

- (ii) Para 4(ii)(a) of CARO, 2003 requires the auditor to state in his report whether physical verification of inventory has been conducted at reasonable interval by the management. Physical verification of inventory is the responsibility of the management which should verify all material items at least once in a year and more often in appropriate cases. The auditor in order to satisfy himself about verification at reasonable intervals should examine the adequacy of evidence and record of verification. In the given case, the above requirement of CARO, 2003 has not been

fulfilled as such and the auditor should point out the specific areas where he believes the procedure of inventory verification is not reasonable. He may consider the impact on financial statement and report accordingly.

- (iii) Para 4(x) of CARO, 2003 requires the auditor to state in his report in respect of a company which is in existence for more than 5 years from the date of registration:
 - (a) whether the accumulated losses at the end of the year are more than 50% of its net worth; and
 - (b) whether it has incurred cash losses during the current year and the immediately preceding financial year.

In the instant case, since the company is covered by the above requirements, there are symptoms of potential sickness and, thus, auditor should report the same. It is, however, to be assumed that the company is in existence for more than 5 years.

Question 15

Under CARO, 2003 how, as a statutory auditor would you comment on the following:

- (i) *Fixed assets comprising 1/3rd of the total assets have been disposed off during the year.*
- (ii) *A Term Loan was obtained from a bank for ₹ 75 lakhs for acquiring R&D equipment, out of which ₹ 12 lakhs was used to buy a car for use of the concerned director, who was overlooking the R&D activities.*

Answer

- (i) **Disposal of Fixed Assets:** Under CARO, 2003, an auditor is required to state if substantial part of the fixed assets have been disposed off during the year, whether it has affected the going concern. This clause requires the auditor to carry out adequate audit procedures to satisfy himself that the company shall be able to continue as going concern for the foreseeable future despite the sale of substantial part of the fixed assets.

Accordingly, in the instant case, the auditor should satisfy himself as to whether disposal off of 1/3rd of fixed assets during the year had any effect on the going concern assumption on account of such sale of fixed assets. The auditor is required to exercise his professional judgement to determine whether disposal off of one-third of total assets constitutes substantial part or not. Depending upon the judgement arrived at by the auditor, he shall report whether substantial part of fixed assets have been disposed off or not during the year and it has affected or not affected the going concern status of the company. Alternatively, in case the auditor is of the opinion that it constitutes substantial sale but the going concern assumption is appropriate because of mitigating factors then he has to ensure that the same are disclosed in the financial statements or else he shall have to modify the auditor report. The manner of reporting shall also be modified appropriately in case the going concern assumption is resolved or not.

- (ii) **Utilisation of Term Loans:** Under CARO, 2003, an auditor is required to comment whether term loans were applied for the purpose for which the loans were obtained.

The auditor should examine the terms and conditions of the term loan with the actual utilisation of the loans. If the auditor finds that the fund has not been utilized for the purpose for which they were obtained, the report should state the fact.

In the instant case, since term loan taken for the purpose of R&D equipment has been utilized for purchase of car which has no relation with R&D equipment. Therefore, car though used for R&D Director cannot be considered as R&D equipment. The auditor should state the fact in his report that the out of term loan of R&D lack, ₹ 12 lakhs was not utilised for the purpose of acquiring the R & D equipment.

Question 16

Bring out the significance of the following two illustrative paragraphs found in the statutory auditor's report in recent days.

(i) *Opening Paragraph:*

"We have audited the attached Balance Sheet of as at 31st March, 2xxx and also the Profit and Loss Account 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".

(ii) *Scope Paragraph:*

"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 whether the financial statements are free of material statement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial presentation. We believe that our audit provides a reasonable basis for our opinion."

Answer

- (i) **Opening Paragraph:** As per SA 700 "Forming an Opinion and Reporting on Financial Statements" the introductory paragraph states, for example, that the auditor has audited the accompanying financial statements of the entity, which comprise [state the title of each financial statement comprising the complete set of financial statements required by the applicable financial reporting framework, specifying the date or period covered by each financial statement] and referring to the summary of significant accounting policies and other explanatory information.

Further, the significance of 'opening paragraph' is to bring to the notice of the users of financial statements that preparation of the accounts is the responsibility of the management of the enterprise, whereas the responsibility of the auditor is to express an opinion on the said accounts based on audit carried out by him. The preparation of such statements requires management to make significant accounting estimates and judgements, as well as to determine the appropriate accounting principles and methods used in preparation of the said statements.

As per SA 700 "Forming an Opinion and Reporting on Financial Statements" the introductory paragraph in the auditor's report shall:

- (a) Identify the entity whose financial statements have been audited;
 - (b) State that the financial statements have been audited;
 - (c) Identify the title of each statement that comprises the financial statements;
 - (d) Refer to the summary of significant accounting policies and other explanatory information; and
 - (e) Specify the date or period covered by each financial statement comprising the financial statements.
- (ii) **Scope Paragraph:** The significance of 'scope paragraph' is to inform the users about the practices and procedures followed in conduct of audit by the auditor. The auditor states in this paragraph that the audit was planned and performed in accordance with generally auditing standards generally accepted in India. The auditor also states that the audit provides a reasonable basis for his opinion. The significance of this paragraph lies in the fact that auditor wishes to convey to readers about the scope of audit by highlighting the nature and process of audit. The test check approach of audit adopted by the auditor in performing his work as also the significant aspect of evaluation of accounting principles and accounting estimates is also clarified. The basic objective of auditing that the auditor provides only "reasonable assurance" is emphasised in this paragraph. In a way, such a statement signifies inherent limitations of audit.

A description of the auditor's responsibility to express an opinion on the financial statements and the scope of the audit, that includes:

- A reference to Standards on Auditing and the law or regulation; and
- A description of an audit in accordance with those Standards;

Question 17

As a Statutory Auditor, how would you report on the following under CARO:

- (i) *O Pvt. Ltd. Is a dealer in Shares and Securities.*
- (ii) *ABC Pvt. Ltd is a Manufacturer of jewellery. A senior employee of the Company informed you that the Company does not properly disclose the purity of gold used on the jewellery.*

Answer

Reporting under CARO, 2003

- (i) O Pvt. Ltd. is a dealer in shares and securities. Clause (xiv) of CARO, 2003 is applicable to a company in case it is dealing or trading in shares, securities, debentures and other investments. The requirements applicable to O Pvt. Ltd. would be as under:
 - whether proper records are maintained for transactions and contracts;
 - whether timely entries are made in such records; and

- whether shares, securities, debentures and other investments have been held by the company in its own name except to the extent of exemption, if any granted under section 49 of the Companies Act, 1956.

In case auditor is satisfied in respect of aforesaid matters, after making examination, the auditor may report as under:

“In our opinion, and according to information and explanation given to us, the company has been maintained proper records in respect of transactions and contracts in securities during the year and timely entries have been made therein. Further, all shares and certificates are held by the company in its own name.”

- (ii) In the case of ABC Pvt. Ltd. If purity of gold is not properly disclosed on the jewellery it amounts to defrauding the customers. That means the management is deceiving customers to obtain an illegal advantage. However, the auditor is concerned with fraudulent acts that cause a material misstatement in financial statements. As long as books of account are not falsified arising out of difference in the purity of gold, i.e., actual cost of the gold and the sale price of gold, it has no implication for the auditor. Further, under CARO, 2003, the auditor may examine this from the view point of maintaining proper records of inventory. But even the requirement of maintaining proper records does not necessitate that purity as such should be mentioned on the gold itself. However, the purity of gold would have implication on the valuation of inventory. But this aspect is not required to be reported under CARO, 2003.

Thus, from the view point of reporting on frauds under CARO, 2003, there is no implication for misstatement in the financial statements. Hence, no reporting is necessary for non-proper disclosure of purity of gold on the jewelry.

Question 18

What are the features of a qualified Audit Report?

Answer

The features of a qualified report are

1. **Clarity:** The auditor must express the nature of qualification, in a clear and unambiguous manner.
2. **Explanation:** Where the auditor answers any of the statutory affirmations in the negative or with a qualification his report shall state the reasons for such answer.
3. **Placement:** All qualifications should be contained in the Auditor's Report. When there are notes which are subject matter of a qualification, the same should preferably be annexed to the Auditors' Report. However a reference to the notes to Accounts in the Auditors' Report does not automatically become a qualification.
4. **Subject to:** The words 'subject to' are essential to state any qualification. The qualification should be preceded by words such as 'subject to' or 'except that' to make it

clear that he is making an exception.

5. **Quantification:** It is also necessary that the auditor should quantify, wherever possible, the effect of individual as well as the total effect of all qualifications on profit or loss and/or state of affairs these qualifications on the financial statements in a clear and unambiguous manner. In circumstances where it is not possible to quantify the effect of the qualifications accurately the auditor may do so on the estimates made by the management after carrying out such audit tests as are possible and clearly indicate that the figures given are based on the estimates of the management.
6. **Nature of qualification:** Vague statements the effect of which on accounts cannot be ascertained like 'the debtors balances are subject to confirmation', 'no provision for taxation has been made in view of the loss during the year' etc., should be avoided.
7. **Violation of law:** Where the company has committed an irregularity resulting in a breach of law, the auditor should bring the same to the notice of the shareholders by properly qualifying his report.
8. **Notes: Report Relationship –** Where notes of a qualificatory nature appear in the accounts the auditors should state all qualifications independently in their report so that the user can assess the significance of these qualifications.
9. **Draft Report:** The auditor may discuss matters of qualification with the management of the company to acquire their views. It is not necessary that the auditor should accept the managements view and modify his opinion. But it would enable the auditor to accurately draft the qualifications in his final report.

Question 19

Write a short note on- Emphasis of matter paragraph in Audit Reports.

Answer

Emphasis of matter paragraph in audit reports: An auditor's report can be modified for matters that do not affect the auditor's opinion. An "emphasis of matter" paragraph is such a type of notification in an audit report. In certain circumstances, such a paragraph is added to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such a paragraph does not affect the auditor's opinion. Such a paragraph is preferably included preceding the opinion paragraph and would ordinarily refer to fact that the auditor's opinion is not quantified in this respect. (Refer SA 700).

An illustration of an emphasis of matter paragraph for a significant uncertainty in an auditor report is as follows :

"Without qualifying our opinion, we draw attention to note X of schedule to the financial statements. The entity is the defendant in a lawsuit alleging infringement of certain patent right and claiming royalties and punitive damages. The entity has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate

of the matter can not presently be determined, and no provision for any liability, that may result, has been made in the financial statements.”

Question 20

The Statutory auditors of Getwell Ltd. included certain comments in his report u/s 227 of the Companies Act, 1956. Since the company requested the auditors to drop the above comments, as otherwise it will affect their future business, as a compromise the auditor included the comment in the report in ordinary type. Comment.

Answer

As per Section 227(3) (e) of the Companies Act, 1956, one of the issues relating to audit report is that the report shall indicate in Bold or in Italics the observations as comments of the auditor which have any adverse effect on the functioning of the company. According to the Guidance Note issued on section 227(3) (e) and (f) of the Companies Act, creates a requirement for the auditor to consider any matter leading to the modification of the auditor report on financial statements is likely to have an adverse effect on the functioning of the company and if so the auditors is required to highlight such matter in Bold or in Italics.

In the instant case, the auditor's action in having printed certain comments in ordinary type is contrary to the provision of the Act and Guidance Note. He will be deemed to have discharged his duties negligently.

Question 21

A Private Limited reports the following position as on 31st March, 2010 :

<i>Paid up capital</i>	<i>30 lacs</i>
<i>Revaluation reserve</i>	<i>10 lacs</i>
<i>Capital reserve</i>	<i>11 lacs</i>
<i>P&T A/c [Dr. Balance]</i>	<i>2 lacs</i>

The Management of the Company contends that CARO 2003 is not applicable to it. Comment.

Answer

As per the Statement on CARO, 2003 issued by ICAI, for determining the applicability of the CARO, 2003 to a private limited company, both capital as well as the revenue reserves shall be taken into consideration while computing the limit of rupees fifty lacs prescribed for paid up capital and reserves. Revaluation reserve, if any, should also be taken into consideration while determining the figure of reserves for the limited purpose of determining the applicability of the Order. The credit balance in the profit and loss account should also be considered as a part of reserve since the balance in the profit and loss account is available for general purposes like declaration of dividend. The debit balance in the profit and loss account, if any, should be reduced from the figure of revenue reserves only. If the company does not have revenue reserves, debit balance of profit and loss account cannot be reduced from the figures

of paid up capital, capital reserve and revaluation reserve.

Accordingly the profit and loss account (Dr Balance) of ₹ 2 lacs cannot be deducted and hence CARO, 2003 is applicable to the Company.

Question 22

PQR Ltd., a listed company and having an average annual turnover of more than ₹ 5 crores has no Internal Audit System. Give your views.

Answer

Internal Audit System and CARO 2003: The Companies Act, 1956 does not require a company to necessarily have an internal audit system. As per Para 4(vii) of CARO, 2003, statutory auditor is required to comment on whether the auditee company has an internal audit system commensurate with its size and nature of its business.

The clause has a mandatory application in respect of listed companies irrespective of the size of paid-up capital and reserves or turnover. For other companies, it is applicable if either of the following conditions is satisfied:

- (a) The company has a paid-up capital and reserves exceeding ₹ 50 lakhs at the commencement of the financial year, or
- (b) The company has an average annual turnover of ₹ 5 crores or more for a period of 3 consecutive financial years immediately preceding the financial year concerned.

In the instant case, PQR Ltd is a listed company and having an average annual turnover of more than ₹ 5 crores. Hence, the auditor will have to mention in his report the fact of not having such internal audit system by the Company.

Question 23

- (a) *OK Ltd. has taken a term loan from a nationalized bank in 2006 for ₹ 200 lakhs repayable in five equal instalments of ₹ 40 lakhs from 31st March, 2007 onwards. It had repaid the loans due in 2007 & 2008, but defaulted in 2009, 2010 & 2011. As the auditor of OK Ltd. what is your responsibility assuming that company has sought reschedulement of loan?*
- (b) *Big and Small Ltd. received a show cause notice from central excise department intending to levy a demand of ₹ 25 lakhs in December 2010. The company replied to the above notice in January 2011 contending that it is not liable for the levy. No further action was initiated by the central excise department upto the finalization of the audit for the year ended on 31st March, 2011. As the auditor of the company, what is your role in this?*
- (c) *Director of T Ltd. draws an advance of US\$ 200 per day in connection with the foreign trip undertaken on behalf of the company. On his return he files a declaration stating that entire advance was expended without any supporting or evidence. T Ltd. books the entire expenses on the basis of such declaration. As the auditor of T Ltd. how do you deal with this?*

Answer

- (a) As per Para 4 (xi) of CARO, 2003 the auditors of a company has to state in his report that whether the Company has defaulted in repayment of its dues to financial institutions or bank or debentures holders and if yes the period and amount of default to be reported.

In this case OK Ltd has defaulted in repayment of dues for three years. Application for rescheduling will not change the default position. Hence the auditor has to report in his audit report that the Company has defaulted in its repayment of dues to the bank to the extent of ₹ 120 lakhs.

- (b) The auditor's report under section 227 the Companies Act, 1956 has to specifically include certain matters specified in Para 4 and Para 5 of CARO 2003.

One of such matter is payment of dues to Government. As per Para 4 (ix)(b) of CARO, 2003, "In case dues of Income Tax/ Sales Tax/ Service Tax/ Customs 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 shall be mentioned. A mere representation to the Department shall not constitute the dispute."

In the present case issuance of show cause notice by Excise Department does not tantamount to demand payable by the Company. In as much as the Company has replied to the notice and no further correspondence was received from the Department, it has to be construed that there is no demand. The auditor needs not to report on this.

- (c) SA 500 "Audit Evidence" states that an auditor should obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base his opinion.

Section 227 (IA) (e) the Companies Act, 1956 requires an auditor to report when personal expenses have been charged to revenue account.

In the context of the facts of case, ascertain whether the payment made by the company for the foreign trip form an "allowance" or "reimbursement". An allowance is a fixed sum of money allowed on the basis of specified criteria. No evidence supporting the expenditure is required for payment of allowance to the director. On the other hand, if the payment is reimbursement should be against actual expenditure.

The director concerned should provide proof of expenditure. Since the director has given only a declaration, the auditor should ascertain other relevant facts as to whether the advance paid is pursuant to the policy of the company which is based on approximate estimation of the expenditure normally incurred by a person of the status of a director and the same is applicable to persons of a similar status within the company. If the auditor considers the advance taken is reasonable then the declaration can be considered adequate, otherwise he may have to call for additional documentary evidences.

Question 24

ABC Private Ltd. has granted loan of ₹ 20 crores to XYZ Ltd. a sister concern and it remains outstanding at the year end. How would you report the fact?

Answer

Reporting of loan under CARO, 2003: As per Paragraph 4(iii) (a) of CARO, 2003 the auditor has to report whether the company has granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 301 of the Companies Act, 1956. If so, give the number of parties and amount involved in the transactions; and further as per Paragraph 4(v)(a) "Whether the particulars of contracts or arrangements referred to in section 301 of the Companies Act, 1956, have been entered in the register required to be maintained under that section".

Hence, in the instant case ABC Private Ltd. has granted loan of ₹ 20 crores to XYZ Ltd., a sister concern needs to be reported as per Paragraph 4 (iii) (a) and 4 (v) (a) of CARO, 2003.

Question 25

XYZ Pvt. Ltd. has submitted the financial statements for the year ended 31-3-11 for audit. The audit assistant observes and brings to your notice that the company's records show following dues:

Income Tax relating to Assessment Year 2007-08 ₹ 125 lacs - Appeal is pending before Hon'ble ITAT since 30-9-09.

Customs duty ₹ 85 lakhs - Demand notice received on 15-9-10 but no action has been taken to pay or appeal.

As an auditor, how would you bring this fact to the members?

Answer

Reporting under Paragraph 4 (ix) of CARO, 2003:

- (i) As per Paragraph 4(ix)(b) CARO, 2003 "In case dues of Income Tax/Sales Tax/Service Tax/ Customs 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 shall be mentioned. However, a mere representation to the Department shall not constitute the dispute."

The auditor should also obtain a management representation about the disputed dues, the amounts involved and the forum where the dispute is pending. The auditor should carry out necessary audit procedures to verify the information provided by the management.

The information may be reported in the Statement of Disputed Dues as nature of the dues, amounts, period which the amount relates and forum where dispute is pending.

In the present case, there is Income Tax demand of ₹ 125 Lacs and the company has gone for an appeal, it needs considerations as to whether the entire demand is disputed, because it is difficult to presume that the demand by Income Tax authority is without any basis. Therefore, As per AS 29 partly to the extent the company considered that the demand is based on some logical basis, that amount may be provided for and the remaining may be disclosed as the contingent liability. Further, it should be brought to notice of members by reporting under Paragraph 4(ix) (b) of CARO, 2003 as per the requirement mentioned therein;

- (II) As per Paragraph 4 (ix) (a), the auditor has to report upon the regularity of the company in depositing undisputed statutory dues including provident fund, investor education and protection fund, employees' state insurance, income-tax, sales-tax, wealth-tax, service tax, custom duty, excise duty, cess and any other statutory dues to appropriate authorities. If the company is not regular in depositing the above mentioned undisputed statutory dues, the auditor is required to state the extent of arrears of statutory dues which have remained 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.

With reference to the regularity, in case of custom duty on import of goods or demands arising on account of assessment orders etc., which a company is required to pay as and when an event giving rise to the liability of the company occurs. Such dues should be construed to have been paid regularly if the company deposits them as and when they become due. However, the auditor would be required to comment upon the regularity of the company in depositing the installments, if any, granted by an authority in respect of a demand against the company.

In the instant case, the demand notice has been received for Custom Duty of ₹ 85 Lacs on 15.09.2010 and is outstanding for more than 6 months, for which no action has been taken by the management, leads to the irregularity which should be brought to notice of members by reporting under Paragraph 4(ix)(a) of CARO, 2003.

Question 26

Under the applicable Standards on Auditing, in what circumstances does the report of the as a statutory auditor require modifications? What are the types of modifications possible to the said report?)

Answer

Modifications in Audit Report: As per SA 700, "Forming an Opinion and Reporting on Financial Statements", the auditor may modify the opinion in the auditor's report in the following circumstances:

- (i) *If the auditor concludes that, based on the audit evidence obtained, the financial statements as a whole are not free from material misstatement; or*
- (ii) *If the auditor is unable to obtain sufficient appropriate audit evidence to conclude that the financial statements as a whole are free from material misstatement.*

If financial statements prepared in accordance with the requirements of a fair presentation framework do not achieve fair presentation, the auditor shall discuss the matter with management and, depending on the requirements of the applicable financial reporting framework and how the matter is resolved, shall determine whether it is necessary to modify the opinion in the auditor's report in accordance with SA 705.

Types of Modification to the Auditor's Opinion: As per SA 705, "Modification to the Opinion in the Independent Auditor's Report", modified opinion may be defined as a qualified opinion, an adverse opinion or a disclaimer of opinion.

Types of modifications possible to the said report are below-mentioned:

- (1) Qualified Opinion : The auditor shall express a qualified opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are material, but not pervasive, to the financial statements; or the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, but the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be material but not pervasive.*
- (2) Adverse Opinion: The auditor shall express an adverse opinion when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements, individually or in the aggregate, are both material and pervasive to the financial statements.*
- (3) Disclaimer of Opinion: The auditor shall disclaim an opinion when the auditor is unable to obtain sufficient appropriate audit evidence on which to base the opinion, and the auditor concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.*

Question 27

Under CARO, 2003, how, as a statutory auditor would you comment on the following:

- (i) X Pvt. Ltd. is a subsidiary of a listed entity incorporated outside India. The management of the company believes that since, X Pvt. Ltd. is a Private Company and satisfies all condition under the Companies (Auditor's Report) Order, 2003, reporting under CARO is not applicable.*
- (ii) A term loan was obtained from a bank for ₹50 lakhs for the purpose of purchase of assets for Research & Development (R & D). Out of these funds, a vehicle was purchased for the use of the concerned director who was in charge of the R & D activities.*

Answer

- (i) Applicability of CARO 2003 : The Companies (Auditor's Report) Order (CARO), 2003*

applies to all the companies including foreign companies as defined in the Companies Act, 1956, except certain categories of companies specifically exempted from the application of the order.

The Companies (Auditor's Report) Order (CARO), 2003, exempts private limited companies from its application which fulfils all the following conditions:

- (1) its paid-up capital and reserves are rupees fifty lakh or less;*
- (2) its outstanding loan from any bank or financial institution are rupees twenty five lakh or less; and*
- (3) its turnover does not exceed rupees five crore.*

In the instant case M/s X Pvt. Ltd. is a subsidiary of a listed entity incorporated outside India and on the basis of contention of the management that it is a private limited company which satisfies all the above mentioned conditions as per CARO 2003.

As a statutory auditor after ensuring the fulfillment of all the above conditions cumulatively, the contention of the management is correct.

Thus, reporting under CARO, 2003 will not be applicable for X Pvt. Ltd. Company.

- (ii) Utilisation of Term Loans: Under CARO, 2003, an auditor is required to comment whether term loans were applied for the purpose for which the loans were obtained.*

The auditor should examine the terms and conditions of the term loan with the actual utilisation of the loans. If the auditor finds that the fund has not been utilized for the purpose for which they were obtained, the report should state the fact.

In the instant case, since term loan taken for the purpose of purchase of assets for Research & Development (R&D) has been utilized for purchase of vehicle for the use of Director which has no relation with assets for Research & Development (R & D). Therefore, vehicle though used for Director who was incharge of the R&D activities, cannot be considered as purchase of assets for Research & Development (R & D). The auditor should state the fact in his report that the out of term loan of R & D, a certain sum was not utilised for the purpose of acquiring the R & D assets.

Question 28

- (a) H Private Ltd had taken overdrafts from two banks with a limit of ₹ 10 lacs each against the security of fixed deposit it had with those banks and an unsecured overdraft from a financial institution of ₹ 9 lacs. The said loans were outstanding as at 31st March 13. The paid up capital and reserves of the company as at that date was ₹ 40 lacs and its turnover during the financial year ended on 31st March*

13 was ₹3 crores. The management of the company is of the opinion that CARO 03 is not applicable to it because turnover and paid up capital were within the limits prescribed and loans taken against the fixed deposits cannot be considered. The company further contended that loan limit is to be reckoned per bank or financial institution and not cumulatively. Comment.

- (b) XYZ Ltd has significant operations in a foreign country. Due to civil and political unrest in that country physical verification of inventory and fixed assets could not be carried out and you are not in a position to obtain audit evidence through other audit procedures also. The value of fixed assets and inventory forms part of 80% of the asset value of the company. As the auditor of XYZ Ltd what factors do you consider in your reporting responsibility. Also draft a suitable report that will be incorporated in the main audit report (Reporting under CARO 03 need not be considered).
- (c) R Ltd. as at 31st March, 2013 defaulted in the repayment of interest and principal due to a financial institution. The due date was 28th February, 2013. However, the defaulted amount was paid on 5th April, 2013. The company's management is of the opinion that since the default is set right before the audit completion these need not be reported in CARO 03. Comment and draft a suitable report.

Answer

- (a) The Companies (Auditor's Report) Order (CARO), 2003, exempts private limited companies from its application which fulfils all the following conditions:
 - (i) its paid-up capital and reserves are rupees fifty lakh or less;
 - (ii) its outstanding loan from any bank or financial institution are rupees twenty five lakh or less; and
 - (iii) its turnover does not exceed rupees five crore.

In the case of H Pvt. Ltd., its paid-up capital is less than ₹50 lakhs, turnover is less than ₹5 crores but its outstanding loan from banks and financial institution is Rs 29 Lakhs. Loans against Fixed deposits are to be taken into consideration to compute the outstanding loan from any bank or financial institution. For the limit of ₹25 Lakhs as loans from banks and financial institutions, all loans from banks and financial institutions are to be taken cumulatively. Hence, the contention of the company is not correct. Here, H. Ltd. does not satisfy all conditions and CARO, 2003, therefore, will be applicable.

- (b) As per SA-501 "Audit Evidence-Specific Considerations for Selected Items", if attendance at physical inventory counting is impracticable, the auditor shall perform alternative audit procedures to obtain sufficient appropriate audit evidence regarding the existence and condition of inventory. If it is not possible to do so, the auditor shall modify the opinion in the auditor's report in accordance with SA 705. In the given case, the auditor has to modify his report.

Following factors are to be considered in auditor's reporting responsibility:

- (a) *Inventories and the Fixed Assets are material to the financial statements.*
- (b) *Auditor is unable to attend physical verification of the inventories and fixed assets. In other words, physical verification becomes impracticable due to civil and political unrest in the foreign country, where the inventory and fixed assets are located, posing threats to the safety of auditor.*
- (c) *Auditor failed to obtain proper and sufficient audit evidence, even by alternative audit procedures.*

Draft of the suitable report to be incorporated in the main audit report:

"Our responsibility is to express an opinion on these financial statements based on our audit in accordance with the Standards on Auditing issued by the Institute of Chartered Accountants of India. Because of the matters described in the Basis for Disclaimer of Opinion paragraph, however, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion.

Basis for Disclaimer of Opinion

We were appointed as auditors of the Company and we report that we could not observe the counting of physical inventories and physical verification of fixed assets due to civil and political unrest in foreign country where the company has significant operation. We were also unable to satisfy ourselves by alternative means concerning the inventory quantities and fixed assets of the company held at March 31st 20XX, which are stated in the Balance Sheet at ₹ XXX and ₹ XXX, respectively.

Disclaimer of Opinion

Because of the significance of the matters described in the Basis for Disclaimer of Opinion paragraph, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly, we do not express an opinion on the financial statements.

Report on Other Legal and Regulatory Requirements

As required by section 227(3) of the Companies Act, 1956, we report that:

As described in the Basis for Disclaimer of Opinion paragraph, we were unable to obtain all the information and explanations which to the best of our knowledge and belief were necessary for the purpose of our audit.

- (c) *As per Para 4 (xi) of CARO, 2003 the auditors of a company has to state in his report that whether the Company has defaulted in repayment of its dues to financial institutions or bank or debentures holders and if yes the period and amount of default to be reported. The auditor should report the period and amount of all defaults existing at the balance sheet date.*

In this case R Ltd has defaulted in repayment of principal and interest falling due on 28-02-2013. As R Ltd defaulted in the repayment of principal and interest, so the auditor has to report in his audit report that the Company has defaulted in its repayment of principal and interest to the financial institution to the extent of defaulted amount. The period of default i.e. 35 days has also to be stated as per this clause.

Draft Report

“The company has defaulted in repayment of principal and interest to the financial institution amounted to ₹....., that become due on 28th Feb, 2013. Also the period of default is 35 days”.