

PAPER – 3: ADVANCED AUDITING

Answer all questions.

Question 1

As an auditor, how would you deal with the following:

- (a) During the audit of ABC Pvt. Ltd. for the year ended 31st March, 2009, it is noticed that the company has not maintained proper books of account and the final accounts were drawn up from the bank summaries. The number of transactions in the entire year for the company were only 30. (5 Marks)
- (b) PQR Ltd. had acquired a Brand from another company for Rs.100 lakhs. PQR Ltd. contends that since the said brand is a very popular and famous brand, no depreciation or amortisation needs to be provided. (4 Marks)
- (c) XY Ltd. had entered into derivative transactions in foreign currency which were based on probable export orders. As at the year end on 31st March, 2009, the mark-to-market (MTM) loss on the said derivatives was Rs.250 lakhs. The company contends that since the MTM loss is notional and likely to be recouped in the next year, the same need not be provided for. (5 Marks)
- (d) The statutory auditor of the Holding Company demands for the working papers of the auditors of the subsidiary company, of which you are the auditor. (4 Marks)

Answer

- (a) Non maintenance of Books of Accounts by Private Limited Company:

Section 209 of the Companies Act, 1956 provides for keeping of proper books of account by a company and the auditor is specifically required to report under section 227. Accordingly, auditors are required to state as to whether proper books of account, as required by law, have been maintained by the company so far as it appears from the examination of the books.

In the instant case, though the members of transactions are small and the final accounts properly drawn up from the bank summaries, the books of account, as required by Section 209 can not be said to have been maintained by ABC Pvt. Ltd., Auditors, therefore, have to state disclaimer of opinion in the audit report.

- (b) Amortization or Depreciation of Brand:

AS 26 "Intangible Assets" provides that an intangible asset should be measured initially at cost. After initial recognition, an intangible asset should be carried at cost less any accumulated amortization and any accumulated impairment losses. The depreciable amount of an intangible asset should be allocated on a systematic basis over the best estimate of its useful life. There is a rebuttable presumption that the useful life of an intangible asset will not exceed ten years from the date when the asset is available for use. The auditor should satisfy himself that the value of brand is amortized in accordance with AS 26, as brand is considered to be an intangible asset.

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The contention of PQR Ltd., that Brand is very popular and famous, no depreciation or amortization needs to be provided, is wrong in view of the above and hence, the auditor will have to qualify in this report this matter and quantify, the amount of non-amortisation.

(c) Derivative transactions (MTM) Loss

The ICAI has issued an announcement "Accounting for Derivatives" in March, 2008 to clarify the best practice treatment to be followed for all derivatives. According to this announcement, the entity is required to provide for losses in respect of all outstanding derivative contracts at the balance sheet date by marking them to market, keeping in view the principle of prudence as enunciated in AS 1 "Disclose of Accounting Policies". The Guidance Note on Accounting for Equity Index and Equity Stock Futures and Options (2003) and AS 11(Revised 2003)* "Effects of Changes in Foreign Exchange Rates". The auditors should consider making appropriate disclosures in their reports if the aforesaid accounting treatment and disclosures are not made. In the given case, XY Ltd. should provide for mark to-market (MTM) losses amounting Rs. 250 Lakhs also provide for the similar treatment. The auditor will have to make necessary disclosures and quantify the amount of MTM losses.

(d) Access to Working Paper

As per SA 230, "Audit Documentation" working papers are the property of the auditor. The auditor may, at his discretion, make portion of or extracts of his working papers available to his client.

SA 600 "Using the Work of Another Auditors" also states that an auditor should respect the confidentiality of information acquired during the course of his audit work and should not disclose such information unless there is a legal or professional duty to disclose. Part I of the Second Schedule to the Chartered Accountants Act, 1949 also provides that a chartered accountant in practice shall be deemed to be guilty of professional misconduct if he "Discloses information acquired in the course of his professional engagement to any person other than his client, without the consent of his client, or otherwise than as required by any law for the time being in force".

The ICAI has clarified that except to the extent stated above, the auditor is not required to provide the client or the other auditors of the same enterprise or its related enterprises such as a parent or a subsidiary, access to his audit working papers. The statutory auditor of an enterprise do not have right of access to the audit working papers of the branch auditor. An auditor can rely on the work of another auditor, without having any right of access to the audit working papers of other auditor.

In view of the above guidelines, issued by the Council of ICAI, the statutory auditor of Holding company can not have access to audit working papers of the subsidiary company's auditor. He can however, ask the auditor to answer certain questions about

*The said guidance note and paragraph 36 to 39 (under the heading forward exchange contracts) of AS 11 (Revised) stand withdrawn from the date AS 30 Financial Instruments: Recognition and Measurement, became recommendatory in nature, i.e. 1-4-2009. AS 30 will be mandatory in respect of accounting periods commencing on or after 1st April, 2011.

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the manner in which the audit is conducted and certain other clarifications regarding audit.

Question 2

Comment on the following with reference to the Chartered Accountants Act, 1949 as amended by the Chartered Accountants (Amendment) Act, 2006 and Schedules thereto:

- (a) M/s MN & Co., a firm of Chartered Accountants prepared and signed the forecast of a company's earnings contingent upon future transactions without mentioning the basis on which the said estimates were prepared. A bank granted a loan to the said company based on the above forecast signed by M/s MN & Co. When the company defaulted in repayment of the loan, the bank filed a complaint against M/s MN & Co. (5 Marks)
- (b) Mr. P, a Chartered Accountant, did not maintain any books of account on the ground that his income did not exceed the limits prescribed u/s 44AA of the Income-tax Act, 1961. (4 Marks)
- (c) M/s ABC, a Kolkata based firm of Chartered Accountants having 5 partners accepts the statutory audit of D Pvt. Ltd for 2008-09 at an audit fee of Rs.5,000. D Pvt. Ltd was incorporated on 1st October, 2005. (5 Marks)
- (d) An auditor of a cooperative society has agreed to charge fees @ 5% of the profits of the society. (4 Marks)

Answer

- (a) Forecast of a company's earning

Clause (3) of the Second Schedule of Chartered Accountants Act, 1949 provides that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he permits his name or the name of the firm to be used in connection with the estimates of earnings, contingent upon future transactions, in a manner which may lead to the belief that he vouches for the accuracy of the forecast.

The Council has issued a guidance note wherein they have considered the implications of the above clause. After consideration of the various factors, council has taken the view that the above clause does not preclude a chartered accountant from associating his name with forecasts. He can participate in the preparation of profit or financial forecasts and also can review them provided he indicates clearly in his report:

- (i) the sources of information
- (ii) the basis of forecasts and
- (iii) the major assumptions made in arriving at such forecasts so long as he does not vouch for the accuracy of the forecasts.

The Council recognises that all forecasts are estimates, based on certain assumptions,

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duly evaluated on a consideration of various relevant factors and as such not capable of being ascertained with accuracy.

In the instant case, the Chartered Accountant can prepare and sign financial forecasts and also can review them, but he must indicate clearly in his report the basis of forecasts etc. as discussed earlier. In the given case, he has not mentioned in his report the bases on which the estimated earnings of the company is ascertained. This made the bank to believe that he had vouched the accuracy of the forecast and advanced the loan, thereby suffering losses.

The Chartered Accountant is guilty of professional misconduct under the above clause. The bank is justified in making a complaint to the Institute against M/s. MN & Co.

(b) Non-maintenance of books of account by a chartered accountant:

In exercise of the powers conferred by clause (ii) of Part II of the Second Schedule to the Chartered Accountants Act, 1949, the Council of the Institute has specified that a member of the Institute in practice, shall be deemed to be guilty of professional misconduct, if he or the firm of chartered accountants of which he is a partner, fails to maintain and keep in respect of his/its professional practice, proper books of account whether the income exceeds the limit prescribed under section 44AA of the Income Tax Act, 1961 or not.

The books of account required mainly are:

- (i) a cash book and
- (ii) a ledger.

In view of the above clause, Mr. P, a chartered accountant will be guilty of professional misconduct.

(c) Minimum audit fees in respect of audit:

According to ICAI guideline, it is specified by the Council that a member of the Institute in practice shall not, on behalf of the firm of chartered accountants in which he is a partner, accept or carry out any audit work involving receipt of audit fees (excluding reimbursement of expenses, if any for such work of an amount less than what is specified hereunder;

- (a) Consisting of 5 or more partners but less than 10 partners with at least one partner holding a certificate of practice for five years or more; or
- (b) Consisting of 10 or more partners with at least one partner holding certificate of practice for five years or more.

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	Practicing firm having 5 or more partners but less than 10 partners	Practicing firm having 10 or more partners
(i) In cities with population of 3 million and above	Rs.6000/- p.a.	Rs.12000/- p.a.
(ii) In cities/towns having population of less than 3 million	Rs.3500/- p.a.	Rs.8000/- p.a.

In view of the above, audit fees charged by M/s. ABC Rs.5000/- is less than the prescribed limit of rs.6000/-. Thus member of the Institute in practice M/s. ABC shall be deemed to be guilty of professional misconduct.

(d) Charging Fees on Percentage Basis.

As per the above clause Chartered Accountant in practice shall charge or offer to charge, accept or offer to accept in respect of any professional work, fees which are based on a percentage of profits or which are contingent upon the findings or result of work, provided that:

- (i) In case of a receiver or a liquidator, the fees may be based on a percentage of the realisation or disbursement of the assets.
- (ii) In the case of an audit of a co-operative society, the fees may be based on a percentage of the paid up capital or the working capital or the gross or net income or profits, and
- (iii) In the case of a valuer, for the purposes of direct taxes and duties, the fees may be based on a percentage of the value of property valued.

As the co-operative society is included in the above exception, the auditor is not guilty of any professional misconduct.

Question 3

- (a) What are the procedures to be followed by a Statutory Auditor in the audit of opening balances if the financial statements for the preceding year were audited by another auditor? (8 Marks)
- (b) Give an illustration of an Audit Report containing 'Emphasis of Matter' for a significant uncertainty. (8 Marks)

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Answer

(a) Audit Procedures for Opening Balances (SA 510)

The sufficiency and appropriateness of the audit evidence, the auditor will need to obtain regarding opening balances, would depend on the following matters:

- The accounting policies followed by the entity.
- Whether the auditor's report contained an unqualified opinion, a qualified opinion, adverse opinion or disclaimer of opinion where the financial statements of the preceding period were audited.
- The nature of the opening balances, including the risk of their misstatement in the financial statements for the current period.
- The materiality of the opening balances relating to the financial statements for the current period.

The auditor will need to consider whether the accounting policies followed in the preceding period as per which the opening balances have been arrived at, were appropriate and that those policies are consistently applied in the financial statements for the current period and where such accounting policies are inappropriate, the same have been changed in the current period and adequately disclosed.

When the financial statements for the preceding period were audited by another auditor the current auditor may be able to obtain sufficient appropriate audit evidence regarding opening balances by perusing the copies of the audited financial statements. Ordinarily, the current auditor can place reliance on the closing balances contained in the financial statements for the preceding period, except when during the performance of audit procedures for the current period, the possibility of misstatements in opening balances is indicated.

When the financial statements of the preceding period were not audited or the auditor is not satisfied by using the procedures described above, the auditor will need to perform other procedures discussed as under:

1. For current assets and liabilities, some audit evidence can ordinarily be obtained as part of the audit procedures performed during the current period. For example, the collection / payment of opening accounts receivable / accounts payable during the current period will provide some audit evidence as to their existence, right and obligations, completeness and valuation at the beginning of the period.
2. For other assets and liabilities, such as fixed assets, investments and long-term debt, the auditor will ordinarily examine the records underlying the opening balances. In certain cases, the auditor may be able to obtain confirmation of opening balances from third parties, for example, for long-term debt and investments.

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- (b) An Illustration of an Audit Report containing emphasis of matter paragraph for a significant uncertainty.

1. An illustration of an emphasis of matter paragraph for a significant uncertainty in an auditor's 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 infringements of certain patent rights 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 outcome of the matter cannot presently be determined, and no provision for any liability, that may result, has been made in the financial statements.

In our opinion -

In our opinion and to the best of our information and according to the explanation given to us, the financial statements 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 ----- as on 31st March 2xxx and
- (b) in the case of the profit and loss account, of the profit/loss for the year ended on that date.
- 2 The addition of a paragraph, emphasising a going concern problem or significant uncertainty is ordinarily adequate to meet the auditor's reporting responsibilities regarding such matters. However, in extreme cases, such as situations involving multiple uncertainties that are significant to the financial statements, the auditor may consider it appropriate to express a disclaimer of opinion instead of adding an emphasis of matter paragraph.

Question 4

- (a) In the context of Audit of Banks, how will you verify the following:
- (i) Contingent liabilities. (4 Marks)
- (ii) Inter office adjustments. (4 Marks)
- (b) Discuss the reporting requirements in Form 3CD of the Tax Audit Report U/S 44AB of the Income-tax Act, 1961 for the following:
- (i) Tax on distributed profits. (4 Marks)
- (ii) Brought forward loss or depreciation allowance. (4 Marks)

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Answer 4

(a) (i) Verification of contingent liabilities in the context of Bank audit

In respect of contingent liabilities, the auditor is primarily concerned with seeking reasonable assurance that all contingent liabilities are identified and properly valued. Auditor should generally follow the audit procedures given below:

- (1) Ascertain whether there are adequate internal controls to ensure that transactions giving rise to contingent liabilities are executed only by persons authorised to do so and in accordance with the laid down procedures.
- (2) Ascertain whether the accounting system of the bank provides for maintenance of adequate records in respect of such obligations and whether the internal controls insures that contingent liabilities are properly identified and recorded.
- (3) Perform substantive audit tests to establish the completeness of the recorded obligations. Such tests include confirmation procedures as well as examination of relevant records in appropriate cases.
- (4) Review the reasonableness of the year end amount of contingent liabilities in the light of previous experience and knowledge of the current year's activities.
- (5) Obtain representation from the management that all contingent liabilities have been disclosed and that the disclosed contingent liabilities do not include any contingencies which are likely to result in a loss and which, therefore, require adjustments of assets or liabilities.
- (6) To verify that the provisions of AS 29, "Provisions, contingent liabilities and contingent assets" have been complied with.

(ii) Verification of Inter-office Adjustments in Bank audit:

Inter-office Adjustments represent the balance of all inter-branch transactions of the bank. The same are to be disclosed "NET". If the inter-office adjustment (Net) is a debit, it is to be shown under "other assets" and if it is a credit, it is shown under "other Liabilities and Provisions". These can be subdivided into segments like DD paid, Inter-branch remittances, Head Office Account, etc.

The auditor should pay special attention to the following points:

- (i) The origin and validity of old outstanding unmatched entries, particularly debit entries. The auditor may also seek confirmation of transactions relating to outstanding.
- (ii) Whether there are any reversal entries indicating the possibilities of irregular payments or frauds.
- (iii) Whether the balances include any items in the nature of cash-in-transit, which remain pending for more than a reasonable period. This is because such items are not expected to remain outstanding beyond a very small period during which they are in transit.

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- (iv) Whether transactions, other than those relating to inter-branch transactions have been included in inter-branch accounts.
 - (v) Any unusual items put through inter-branch accounts as well as old or large entries outstanding in inter-branch accounts should be carefully looked into. The auditor may also seek explanations from the management in this regard.
- (b) Reporting requirements in Form 3 CD of the Income Tax Report u/s.44AB of Income Tax Act, 1961

(i) Tax on distributed profits

Section 115-O provides for a special levy at the prescribed rate, on the amount of dividend declared, distributed or paid by domestic company whether such dividend is out of current profit or accumulated profits. The tax auditor has to report on profit distributed during the financial year and therefore the amount of tax paid on such distributed profit at the prescribed rate plus surcharge at the applicable rate on tax and education cess thereon, the dates of payment with amount, has to be reported in this clause.

(ii) Brought forwards loss or Depreciation allowances:

The manner of reporting:

S.No	Ass. Year	Nature of loss/allowance (in rupees)	Amount as returned (in rupees)	Amount as assessed	Remark

For giving the above information, the auditors should verify the assessment records i.e.,

- ◆ Income tax return filed.
- ◆ Assessment orders
- ◆ Appellate orders
- ◆ Rectification / revision orders of the earlier years and ascertain if the figures given in the above clause are correct.

Question 5

- (a) As a Statutory Auditor, how do you verify the existence of Related Parties and disclosure of Related Party Transactions? (8 Marks)
- (b) Draft an illustrative engagement letter for an engagement to compile financial statements of DEF Ltd. (8 Marks)

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Answer

(a) SA 550 Related Parties: Its Existence and Disclosure

SA 550 "Related Parties" establishes standard on the auditor's responsibilities and audit procedures regarding related parties and transactions with such parties. It requires that the auditor should perform audit procedures designed to obtain sufficient appropriate audit evidence regarding the identification and disclosure by management of related parties and the related party transactions that are material to the financial statements. The auditor should review information provided by the management of the entity, identifying the names of all known related parties and should perform the following procedures in respect of the completeness of this information:

- (a) review the working papers for the prior years for names of known related parties;
- (b) review the entity's procedures for identification of related parties;
- (c) inquire as to the affiliation of directors and key management personnel, officers with other entities;
- (d) review shareholders records to determine the names of principal shareholders or, if appropriate, obtain a list of principal shareholders from the share register;
- (e) review memorandum and articles of association, minutes of the meetings of shareholders and the board of directors and its committees and other relevant statutory records such as the register of directors' interest;
- (f) inquire of other auditors (Internal auditor, special auditors appointed under any statute, cost auditors and concurrent auditors) of the entity as to their knowledge of additional related parties and review the report of the predecessor auditors;
- (g) review the entity's income tax returns and other information supplied to regulatory agencies; and
- (h) review the joint venture and other relevant agreements entered into by the entity.

If, in the auditor's judgment, the risk of significant related parties remaining undetected is low, these procedures may be reduced or modified as per the circumstances.

Where the financial reporting framework requires disclosure of related party relationships, the auditor should satisfy himself that disclosure is adequate.

Finally, if the auditor is unable to obtain sufficient appropriate audit evidence concerning related parties and transactions with such parties or conclude that their disclosure in the financial statements is not adequate, the auditor should express a qualified opinion or a disclaimer of opinion in the report, as may be appropriate.

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- (b) As per SRS 4410 “Engagements to compile Financial Information” an illustration report of an Engagement Letter for a Compilation of financial statements is given below:

(Date)

To the Board of Directors (or other appropriate representatives of senior management):

You have, vide your letter dated _____ requested that we compile the balance sheet of _____ (name of the company) as at _____ (date) and the related profit and loss account and the cash flow statement for the year ended on that date. We are pleased to confirm our acceptance and understanding of the engagement by means of this letter. As no audit or review engagement procedures would be carried out, no opinion on the financial statements will be expressed. Further, our engagement cannot be relied upon to disclose whether frauds or defalcations, or illegal acts exist. However, we will inform you of any such matters which might come to our attention in the course of the engagement.

As management, you are responsible for:

- (a) the accuracy and completeness of the information supplied to us, including maintenance of adequate accounting records and internal controls and selection and application of appropriate accounting policies.
- (b) preparation and presentation of the financial statements of the entity, in accordance with the applicable laws and regulations, if any.
- (c) safeguarding the assets of the entity and also establishing appropriate controls designed to prevent and detect fraud and other irregularities.
- (d) ensuring that the activities of the entity are carried in accordance with applicable laws and regulations and that it institutes appropriate controls to prevent and detect any non-compliance.

You will confirm that events and transactions are recorded in accordance with the applicable Accounting Standard(s), issued by the Institute of Chartered Accountants of India and other recognised accounting principles and practices and inform us of any departures therefrom.

As part of our normal procedures, we may request you to provide written confirmation of any information or explanations given to us orally during the course of our work.

We understand that the intended use and distribution of the information we have compiled is _____ (specify).

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We look forward to full cooperation with your staff and we trust that they will make available to us whatever records, documentation and other information requested in connection with our engagement.

Our fees will be billed as the work progresses.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our compilation of your financial statements.

XYZ & Co.
Chartered Accountants
.....

Signature

Question 6

Write short notes on the following:

- (a) Register of Claims for General Insurance Companies
- (b) Current Period Consolidation Adjustments
- (c) External Confirmations in Audit
- (d) Propriety elements in CARO, 2003.

(4x4=16 Marks)

Answer

- (a) Register of claims for General Insurance Companies

The following register and records are generally prepared in respect of claims by the General Insurance Companies:

- (i) Claims intimation register.
- (ii) Claims paid register.
- (iii) Claims Disbursement bank book.
- (iv) Claims Dockets, normally containing the following records:

Claim intimation, claim forms, particulars of policy, survey report, photograph showing damage, Repairer's bills, letter of subrogation, police report, fire service report, claim settlement note, claim satisfaction note, salvage report, salvage disposal note, claims discharge voucher etc.

- (v) Report of quality assurance team and
- (vi) Salvage register.

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(b) Current Period Consolidation Adjustment

These are those adjustments made in the accounting period for which consolidated financial statements are prepared. Current period consolidation adjustments primarily relate to elimination of intra-group transactions and account balances including:

- (a) intra-group interest paid and received or management fees, etc;
- (b) unrealised intra-group profits on assets acquired from other subsidiaries;
- (c) intra-group indebtedness;
- (d) adjustments relating to harmonising the different accounting policies being followed by the parent enterprise and its subsidiaries;
- (e) adjustments made for effects of significant transactions or other events that occur between the date of the financial statements of the parent and one or more of the components, if the financial statements to be used for consolidation are not drawn upto the same reporting date; and
- (f) determination of movement in equity attributable to the minorities since the date of acquisition of the subsidiary.

(c) SA 505 External Confirmations in Audit

SA 505 “External Confirmations” establishes standards on the auditor's use of external confirmations as a means of obtaining audit evidence. According to SA, the auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence to support certain financial statement assertions. In making this determination, the auditor should consider materiality, the assessed level of inherent and control risk, and how the evidence from other planned audit procedures will reduce audit risk to an acceptably low level for the applicable financial statement assertions. The auditor should employ external confirmation procedures in consultation with the management.

SA 500 indicates that, in general, audit evidence obtained from external sources is more reliable than audit evidence generated internally, and that written (documentary) audit evidence is more reliable than audit evidence in oral form. Accordingly, audit evidence in the form of written responses to confirmation request received directly by the auditor from third parties who are not related to the entity being audited, when considered individually or cumulatively with audit evidence from other procedures, may assist in reducing audit risk for the related financial statement assertions to an acceptably low level.

Situations where external confirmations may be used include the following:

- Bank Balances and other information from bankers
- Accounts receivable balances
- Stocks held by third parties
- Property title deeds held by third parties
- Investments purchased but delivery not taken

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- Loans from lenders
- Accounts payable balances
- Long outstanding share application money.

(d) Propriety elements in CARO, 2003

Propriety audit stands for verification of transactions on the tests of public interest, commonly accepted customs and standards of conduct. The following are the propriety elements of CARO, 2003:

- (a) If the company has given or taken loans, secured or unsecured to/from companies, firms or other parties listed in the register maintained under Section 301 of the Companies Act, whether the rate of interest and other terms and conditions of such loans are prima-facie prejudicial to the interests of the company.
- (b) If overdue amount of loan the given to or taken from companies firms or other parties listed in the register maintained under Section 301 of the Companies Act, is more than Rupees one lakh, whether reasonable steps have been taken by the company for recovery/payment of principal and interest.
- (c) Whether particulars of contracts or arrangements referred to in Section 301 of the Act have been entered in the register required to be maintained.
- (d) Is the company regular in depositing undistributed statutory dues like Provident fund, Employee State Insurance, Income Tax, Sales Tax, Service Tax etc. with the appropriate authorities.
- (e) Whether the company has made any preferential allotment of shares to parties and companies covered in the register maintained under section 301 of the Companies Act, 1956 and if so whether the price at which the shares have been issued is prejudicial to the interest of the company.