Companies (Auditor's Report) Order 2003 a stock taking

R. Sarathy W

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In life, everyone talks about a matter or no one speaks about it. Well, the flavour of the month for June 2003 in professional circles is CARO (abbreviated form). Hear the beat? CARO is admired by some as magnificent without malice and criticised by a few as malignant due to unimaginable extent of responsibilities it casts on the audit profession. It is a new age report and represents the vision for the next decade. The Central Government has not gone on wolf shopping to buy sheep's clothing but translated its dreams and Wishes in a quick open-book preparation to achieve distinction.

Section 227(4A) of the Companies Act empowers the Central Government to direct by a general or special order that in the case of specified classes of companies, the auditor's report shall include a statement on such matters as may be specified in its order. In accordance with these provisions, the Central Govern-ment issued the manufacturing And Other Companies (Auditor's Report) Order in 1988 which superseded the earlier order issued in 1975. This is also going away and the Central Government has issued the new Companies (Auditor's Report) Order, 2003. The Order has been published in the Gazette on 12th June 2003.

The MAOCARO as it is popu-larly called has lived for 15 years. It looked glamorous in the first 5 to 6 years of introduction and later became a mundane affair losing its charm to both audit profession and to the corporate world. At best students of law and accounting read this report which was getting routinely annexed to the auditor's report. The CARO which would replace the existing MAOCARO is just born (also suddenly?) — It Is prahalada like, seeming to utter the twin mantra of corporate governance and investor protection from day one. The CARO represents the accumula-ted knowledge and wisdom gained by the law makers from the current developments who have endea-voured to trap and report the irregu-larities and non conformities, if any, through the auditor's report. The MAOCARO has 27 clauses. CARO which is red hot has 21 canine clauses with sub clauses.

Unlike 227(lA) which contains six specific matters which are to be examined by the auditor and which need not be reported upon unless the auditor has any finding or observation, the matters listed whether in MAOCARO or CARO under 227(4A) need to be stated in the auditor's report even where he is satisfied about them.

The MAOCARO created parti-tions for different class of companies. Problems arose in determining the class in which a company falls. Borrowing the example from the statement on MAOCARO by ICAI (para 20), a construction company may not be a manufacturing company but a service company. While subsequent clarifi-cations by the Department of Company Affairs have been of help,

W General Manager (F) Sundaram Claytone Ltd. Chennai

the new CARO has eliminated the type or class of companies. It is one running Order that is applicable to all companies save for the exceptions ruling out scope for debate.

The author's views are given in italics.

Matters to be included in the auditor's report : — Statement of comparison (Paragraph 4 of the Order)

Manufacturing and other Companies (Auditor's Report) Order, 1988 (MAOCARO)	Companies (Auditor's) Report Order, 2003 (CARO)
Effective date The Order came into force on 1st November 1988 and applies to a report made by the auditor on accounts in respect of a financial year which ends on or after 1st November 1988 *By implication, the Order is valid upto a financial year that ends before 1st July 2003.*	**Effective date** The Order comes into force on 1st July 2003 and applies to a report made by the auditor on accounts in respect of a financial year which ends on or after 1st July 2003 (para 3)
Applicability Applicable to every company including a foreign company as defined in section 591 of the Companies Act which is engaged in a. manufacturing, mining or processing; b. supplying and rendering services; c. tradlng; d. the business of financing, investment, chit fund, nidhi or mutual benefit societies;	***Applicability*** Applicable to every company including a foreign company as defined in section 591 of the Companies Act

The classification based on activities has been dispensed with. It is difficult to understand why the definitions of manufacturing company, mining company etc are still appearing in para 2 of the new Order

It did not apply to:	***It does not apply to:***
a. Banking company b. Insurance company c. Section 25 company	a. a banking company b. an Insurance company c. a Section 25 company d. a private company with a paid-up capital and reserves not more than Rs.50 lakhs and has not accepted an public deposit and does not have loan outstanding Rs.l0 lakhs or more form any bank or financial institution and does not have a turnover exceeding Rs.5 crores
Plantation companies producing coffee, tea, rubber etc and not also engaged in processing their products, and real estate companies though not expressly exempt were not coming under any of the three groups A,B,C specified in the Order and hence no audit report is being given.	*The plantation and real estate companies do not find place in the list of exemption and in view of universal applicability, it appears that these companies are also covered now. This matter is not beyond doubt and needs to be clarified by DCA.*

- *Small private companies with no public money involved are being exempted from the rigours of the Order. The requirement of zero public deposit is superfluous as a private company is prohibited from taking public deposits u/s 3(1)(iii)(d) of the Companies Act.*
- *The parameters of exemption are cumulative. They are not formed to be mutually compatible. A debt equity ratio of 1:1 is normal as per good principles of financial management in the absence of adverse factors. Thus for a capital of Rs 50 lakhs, a debt of Rs 50 lakhs is reasonable in today's world of capital requirement and if this is laid down as Rs 10 lakhs, it is a solitary reaper's story that there will be hardly any takers of this exemption. There is also a optimistic school of thought that while the government has not allowed any amount in respect of public deposit, it is prepared to consider upto Rs 10 lakhs in respect of banks / FI which are*

(a) (i)	Whether the company is maintaining proper records showing full particulars including quantitative details and situation of fixed assets.	(i) (a)	Reporting requirement retained
	Whether the assets are physically verified by the management at reasonable intervals.	(i) (b)	Retained.
	Whether any material discrepances were noticed	(i) (b)	Retained

	on verification. Whether the discrepancies has been properly dealt with in the books of accounts.	(i) (b)	Retained
(a) (ii)	Whether any of the fixed assets have been revalued during the year. If so, indicate the basis of revaluation.		Reporting requirement deleted.

in turn based on public money.

- *Even though it is deleted, Accounting Standard (AS) 10 on Accounting for Fixed Assets, which is mandatory, requires disclosure on revaluation in financial statements and in the event of non-compliancy it will be the duty of auditor to bring this in their report (Para 6 of Preface)*
- *Moreover, AS 10 is a specified standard u/s 211 (3C) and any deviation there from is to be reported u/s 211 (3B) read with s.227(3)(d).*

		(i) (C) Added	New reporting requirement If a substantial part of fixed assets have been disposed off during the year, whether it has affected the going concern.

Accounting Standard (AS) 1 on 'Disclosure of Accounting Policies' observes that going concern is a fundamental accounting assumption underlying the preparation and presentation of financial statements. The enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of the operations. Companies are not required to confirm the validity of going concern assumption in their financial statements.

Taking the clue from this, if owing to substantial disposal of fixed assets, the production potential i.e. scale of operations and revenue are materially going down, we can say that going concern status is under doubt. A point to be noted. Managements dispose fixed assets if the products in that line of business persistently suffer from very low or negative margins due to price war or shrinking markets and continue with other profitable lines, as a strategy to improve the return on investment. The going concern status is therefore to be assessed at the company level reckoning the relevant forecast and not at the root level of its constituent business units. This is more so as the auditor's report is for the company as a whole. In the case of demergers, the auditor has to evaluate going concern status on a case to case basis.

Unlike section 293(1)(a) of the Companies Act, CARO u/s 227 does not mention in terms of undertaking(s) i.e. business unit. In the case before the Bombay High Court in P.S. Offshore Inter Land Services Pvt. Ltd. v. Bombay Offshore Suppliers & Services Ltd., Justice Dhanuka J. observed in the matter of section 293(1)(a) of the Companies Act 1956, that "the test to be applied would be to see whether the business of the company could be carried on effectively even after disposal of the assets in question or whether the mere husk of the undertaking would remain after disposal of the assets?" This landmark judgement needs to be kept by the auditor in mind.

If in the well considered opinion of the auditor the going concern status is not complied with, he should spell out the rationale with reference to both internal and external factors The valuation of fixed assets, inventories and unquoted invest-ments (short-term and long-term) may have to be at their estimated net realizable values. The SAP 16 issued by ICAI on appropriateness of going concern is a gold mine to the members.

(a) (iii)	Whether the finished goods, stores, spare parts and raw materials have been physically verified by the management at reasonable intervals.	(ii) (a)	whether physical verification of inventory has been conducted at reasonable intervals by the management;

- *The expression inventory is substituted though it is not defined in the Order. The term inventory is broader in view and would include shares, debentures and other financial instruments held as stock in trade, work in progress, loose tools etc. In this regard, a reference may be made to para 4 of AS 2 on inventories.*
- *Further, what constitutes reasonable interval has not been*

(a) (iv)	Whether the procedures of physical verification of stocks by the management are reason-	(ii) (b)	Retained *The expression 'stocks' is replaced by 'inventory'*

	able and adequate in relation to the size of the company and the nature of its business. If not, the inadequacy in procedures should be reported		
(a) (v)	Whether any material discrepancies have been noticed on physical verification of stocks. If so whether the same have been properly dealt with in the books of accounts.	Added	**Modified reporting requirement** *Retained* Whether the company is maintaining proper records of inventory.

laid down even in CARO. The Statement on MAOCARO by ICAI supposes that management should verify all material items at least once in a year (para 29).

- *In the author's view, a good inventory record is one that contains quantities and values location wise, item wise, with receipts and issues document wise for each category of inventory. Be it ERP or non ERP system environment, the record keeping should be dynamic.*
- *A proper inventory record always includes proper upkeep of its supporting documents in*

(a) (vi)	Whether the auditor is satisfied that valuation of stocks is fair and proper in accordance with the normally ac-		Reporting requirement deleted.

	cepted accounting principles and whether the basis of valuation of stocks is same as in the preceding year. If there is any material deviation in the basis of valuation, the effect of such deviation should be reported.		Deleted

safe & retrievable form be it goods received note, job orders, subcontract issues, scrap notes, finished goods transfers, invoices etc.

(a) (vii)	If the company has taken any loan, secured or unsecured from companies under the same management as defined in sub section 1B of Section 370 of the Companies Act, 1956 and / or from companies, firms or other parties listed in the register maintained under section 301 of the Companies Act, 1956. If yes, whether the rate of interest and other terms and conditions of such loans are	(iii) (a) Added	Modified reporting requirement There is a merger of the existing clauses (vii) and (viii) i.e. taking / granting loans clubbed together. Has the company either granted or, taken any loans, secured or unsecured to/ from companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of

	prima facie prejudicial to the interests of the company.		parties and amount involved in the transactions
(a) (viii)	Whether the company has granted any loan, secured or unsecured to companies under the same management as defined in sub section 18 of Section 370 of the Companies Act, 1956 and / or to companies, firms or other parties listed in the register maintained under section 301 of the Companies Act, 1956. If yes, whether the rate of interest and other terms and conditions of such loans are prima facie prejudicial to the interests of the company.	(iii) (b)	Whether the rate of interest and other terms and conditions of loans given or taken by the company, secured or unsecured, are prima facie prejudicial to the interest of the company *The clause is open. In simple reading, it is found to apply for all loans given / taken unlike MAOCARO which limited itself to S 301 parties*
	Whether the company has given any loans or advances in the nature of loans. If yes, whether the parties are repaying the principal amounts as stipulated and	(iii) (c)	Whether payment of the principal amount and interest are also regular; New reporting requirement:
		(iii) (d)	If overdue amount is more than one lakh, whether reasonable steps have been taken by the company for recovery / payment of the principal and interest;

	interest regularly. If not, whether reasonable steps have been taken for recovery of the said principal amount and interest.		

It appears that since the valuation of inventories is addressed by AS 2 which is a standard specified u/s 211 (3C), the clauses have to be deleted to avoid repetition u/s 277 (4A).

- *Earlier, the auditor's duty would arise when the companies firms or parties were listed in the register. There could be omission in entering the name and particulars in the register. Considering this, it may be seen in para 33(b) of Statement on MAOCARO the ICAI has advised that the auditor should obtain information from the management of the company to overcome the risk of non-maintenance / improper mainten-ance of the register with a caution that the auditor mention the fact of non-maintenance etc while reporting. This wisdom is now formalized in CARO. Now the emphasis is whether it is covered u/s 301 and not the mere act of getting entered in the register. It will be the obligation of managements not to withhold any particulars from the auditors*
- *The Companies (Amendment) Act 1999 has abolished the provisions of Section 370 effective 31.10.98 and accordingly obsolete references taken out in CARO.*
- *Also, MAOCARO required the auditor to comment on the steps*

(a) (x)	Is there an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the purchase of stores, raw materials including components, plant and machinery, equipment and other assets and for the sale of goods?	 (iv) Added	Modified Reporting requirement Is there an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets and for the sale of goods? Whether there is a continuing failure to correct major weaknesses in internal control. *DCA to clarify whether this pertains to above three items only* *Is continuing failure acceptable if weaknesses are minor ? Is materiality to be looked at ?*
(a) (xi)	Whether the transactions of purchase of goods and materials and sale of goods, materials and services made during the year with parties listed in 301 regis-	(v) (a)	Whether transactions that need to be entered into a register in pursuance of section 301 of the Act have been so entered;

	ter, and aggregating to Rs.50, 000/- or more with reference to each party during the year, have been made at reasonable prices having regard to prevailing market prices or comparable prices for similar transactions with other parties.	(v) (b)	Whether each of these transactions have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time (This information is required only in case of transactions exceeding the value of five lakh rupees in respect of any party and in any one financial year)

taken for recovery irrespective of whether the default amount is small or big. CARO imposes the requirement only if the overdue amount is crossing a lakh of rupees.

- *The source for obtaining information is Form 24AA notice given by the director pursuant to section 299 once a year. In the absence of it, the auditor has to rely on the representation letter from the management read with minutes of the Board meeting.*
- *The amount has been increased from Rs 50,000 to Rs 5,00,000 probably on grounds of inflation and materiality.*
- *The auditor is not a commercial man of the industry he audits. The*

(a) (xii)	Whether any unserviceable or damaged stores, raw materials or		Reporting requirement deleted

	finished goods have been determined, and if so whether provision for loss, if any, have been made in the accounts.		The matter is addressed by AS2 in para 20.
(a) (xii)	In case the company has accepted any deposits from the public: Whether it has complied with the provisions of section 58A and the directions issued by the RBI in this regard? And if not, the nature of contravention should be stated.	(vi) Added	In case the company has accepted deposits from the public, whether the directives issued by the Reserve Bank of India and the provisions of Sections 58A and 58AA of the Act and the rules framed there under, where applicable, have been complied with. If not, the nature of contraventions should be stated;
		Added	If an order has been passed by Company Law Board whether the same has been complied with or not ?

concept of comparable prices has remained only on books and hence a realistic case for removal.

- *Purchase of services which were excluded in MAOCARO are covered in S. 301.*
- *This is a welcome inclusion. In the event of default in repayment of deposit, the CLB may on its own or on the application of the depositor on in public interest direct by order the company to make repayment of deposit. The information on compliance is crucial to the stakeholders. In an era of vanishing companies that leave their shell deceiving the innocent public of their money, the stakeholders should know the true financial status through this annual reporting by the auditor.*
- *The provisions of Section 58A*

(a) (xiv)	Is the company maintaining reasonable records for the sale and disposal of realizable by-products and scraps, where applicable		Reporting requirement deleted
(a) (xv)	Whether the company had a paid up capital exceeding Rs.25 lakhs as at the commencement of the concerned financial year or had an average annual turnover exceeding Rs.2 crores for a period of three consecutive financial years immediately preceding the financial year concerned. If 50, whether the company has an internal audit system commensurate with its size and nature of its business.	(vii)	Reporting requirement modified In the case of listed companies and/or other companies having a paid-up capital and reserves exceeding Rs.50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding 5 crore rupees for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business.

apply to deposits accepted by a company whether from small or other depositors. Section 58AA was introduced by Companies (Amendment) Act 2000 laying down special protective provisions in respect of deposits accepted from small depositors.

- *For listed companies irrespective of its capital or turnover, the auditor will have to report on the adequacy and effectiveness of internal audit system. The expression and/or has created some doubts. If we refer to 'The Law Lexicon' it states when expression "and/ or "is used, that word may be taken as will best effect the purpose the purpose taken as a whole. If it is argued that even in respect of listed companies, the amounts would apply, then the very purpose of its specific inclusion is defeated and the original status could have been maintained.*
- *For unlisted companies, the enhanced turnover and capital amounts, will now apply.*
- *Further, instead of paid up capital, now it is paid up capital and reserves. The doubt arises whether credit balance in P&L is a reserve. In the author's view, such credit balance is only a surplus. It is not something, which has been transferred as*

(a) (xvi)	Whether the company is required to maintain the cost records as per section 209(1)(d) of the Companies Act, 1956. If so whether such accounts and records have been made and maintained.	(viii)	Reporting requirement retained
(a) (xvii)	Whether the company is regularly depositing the Provident Fund and ESI dues with the appropriate authority. If not, the extent of arrears of Provident Fund and ESI dues shall be indicated by the auditor.		Reporting requirement enlarged
(a) (xviii)	Whether, as on the last date of the financial year concerned, any undisputed amount payable in respect of Income-tax, wealth tax, sales tax, customs duty and excise duty were outstanding for a period of more than six months from the date they became payable. If so, the amounts of such outstanding dues should be reported.	(ix) (a)	Whether the company is regular in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Employees' State Insurance, Income-tax, Sales-tax, Wealth Tax, Custom Duty, Excise Duty, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor .
		(ix) (b)	In case dues of sales tax/ income tax / custom duty / wealth tax / excise duty / cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending may please be mentioned. (A mere representation to the Department shall not constitute the dispute).

such to a reserve as required under Companies (Transfer of Profits to Reserves) Rules, 1975 and hence cannot be considered as a reserve. Further as per the Guidance Note on Terms used in Financial statements, surplus denotes the credit balance in P&L (15.21).

- *CARO does not meekly stop with PF & ESI. It now includes direct and indirect taxes as well*
- *MAOCARO calls for reporting on undisputed dues. CARO calls for reporting on both undisputed and disputed dues. When the Order of the Deputy Commi-ssioner / Commissioner is not in favour, the company feels that the same is not legally tenable and pursues the matter in appeal. If the company loses the case, it ends up paying the disputed amount (including interest) which is sometimes so huge that if swallows 1% to 2% of turnover and adversely affects loan repayment and dividend decisions. This is conspicuous in central excise cases. Strictly speaking, the companies will have to add a footnote to the balance sheet showing separately the claims against the company not acknowledged as debts which is a basic requirement of Part I of Schedule VI. Frightened by the black mark on corporate governance, the management may refrain from making disclosure of such disputed dues.. The inclusion of disputed dues in auditor's report is therefore an ensured (for presence) and insured measure (against omission). The clause does not call for the assessment of the dispute and its probable outcome by the company's auditor.*
- *The clause (ix)(b) applies to crystallized liabilities as it refers to' dues that have not been deposited' and not to contingent liabilities. The Naresh Chandra Committee in their recommendation no 2.5 have observed that it is important for investors and shareholders to get a clear idea of a company's contingent liabilities because these may be significant risk factors that could adversely affect the corporation's future health. The Committee recommends that management should provide a clear description in plain english of each material liability and its risks, which should be followed by the auditor's clearly worded comments on the management view. This section should be highlighted in the*

significant accounting policies and notes on accounts as well as, in the auditor's report, where necessary. Thus the Committee has suggested that even contingent liabilities should be reported by the auditor. This however has not

(a) (xix)	Whether personal expenses have been charged to the revenue account. If so, the details thereof should be reported.		Reporting requirement deleted This is duplication in reporting. It is already covered under S.227 (1A) (e) as one of the six matters which the auditor has to inquire.
(a) (xx)	Whether the company is a sick industrial company within the meaning of Clause (0) of sub-section (1) of Section 3 of the Sick Industrial Companies (Special Provisions) Act, 1985 (referred SICA) If so, whether a reference has been made to the BIFR under section 15 of that Act. The Bill for repealing SICA is pen-ding before the Parliament and till it is repealed, the auditor's reporting under this clause for financial year ending before 1st July 2003 will have to continue.	(x)	Modified reporting requirement Whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than fifty per cent of its net worth and whether it has incurred cash losses in such financial year and in the financial year immediately preceding such financial year also;

been implemental in the new CARO.

- *Under MAOCARO, the arrears in respect of PF & ESI require reporting however short the period of arrears is while other specified dues are to be reported if they are payable for more than 6 months. CARO would require reporting of all undisputed dues including PF & ESI if they are payable for more than 6 months.*

CARO would be applicable to all companies unlike MAOCARO which limited itself to industrial companies.

The inclusion of cash losses (which is not a criterion for

		(xi)	Whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported
		(xii)	Whether adequate documents and records are maintained in cases where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities; If not, the deficiencies to be pointed out.

B. In case of service companies :			
(b) (i)	All the matters specified in Clause (A) to the extent to which they are applicable.		*CARO is equally applicable to service companies, However, certain clauses specifically applicable under MAOCARO have been deleted.*
(b) (ii)	Whether the company has a reasonable system of recording receipts, issues and consumption of material and stores and allocating materials consumed to the relative jobs commensurate with its size and nature of its business.		Deleted
(b) (iii)	Whether the company has a reasonable system of allocating man-hours utilised to the relative jobs, commensurate with its size and nature of its business.		Deleted
(b) (iv)	Whether there is a reasonable system of authorisation at proper levels and an adequate system of inter-		Deleted

	nal control commensurate with the size of the company and the nature of its business on issue of stores and allocation of stores and labour to jobs.		
C	**In case of a trading company**		
(c) (i)	All the matters specified in Clause (A) to the extent to which they are applicable.		*CARO is equally applicable to trading companies. However, certain clauses specifically applicable under MAO-CARO have been deleted.*
(c) (ii)	Have the damaged goods been determined and if the value of such goods is significant, has provision been made for the loss?		Deleted
D	**In case of finance, investment, chit fund, nidhi or mutual benefit company**		
(d) (i)	All the matters specified in Clause (A) to the extent to which they are applicable;		No separate clauses category wise
		(xiii)	Whether the provisions of any special statute applicable to chit fund have been duly complied with? In respect of nidhi/ mutual
(d) (ii)	Whether the company has granted loans and advances on the basis of security by way of		

	pledge of shares, debentures and other securities. If so, whether adequate documents and records are maintained?		benefit fund/ societies:
		(xiii) (a)	whether the net-owned funds to deposit liability ratio is more than 1:20 as on the date of balance sheet;
(d)(iii)	Whether the provision of any special statute applicable to Chit Fund, Nidhi or Mutual Benefit Society have been duly complied with.	(xiii) (b)	whether the company has complied with the prudential norms on income recognition and provisioning against sub-standard/default/loss assets;
		(xiii) (c)	whether the company has adequate procedures for appraisal of credit proposals/request, assessment of credit needs and repayment capacity of the borrowers;
		(xiii) (d)	Whether the repayment schedule of various loans granted by the nidhi is based on the repayment capacity of the borrower and would be conducive to recovery of the loan amount;
		(xiv)	Reporting requirement re-

(d) (iv)	If the company is dealing ortrading in shares, securities, debentures and other investments, whether proper records have been maintained of the transactions ond contracts and whether timely entries have been made therein. Also whether the shares, securities, debentures and other investments have been held by the company in its own name except to the extent of the exemption if any, granted under section 49 of the Companies Act, 1956.		tained

determining a sick industrial company under S 2(46AA) introduced by the Companies (Second Amendment) Act, 2002) is a good thought. But it appears that cash losses have to be reported starting from the year in which the net worth is eroded by 50%. This may not give a early warning signal to shareholders on potential sickness. It is preferable if auditors are required to report on cash loss incurred in any financial year.

Other new reporting requirements included in 2003 order

(xv) whether the company has given

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

This is a welcome clause. The guarantee may or may not be accompanied by security. In case of default in repayment of the loan by the borrower, the corporate guarantee provided may be encashed or realized by the lender.

Legally, the auditor could refer to the resolution passed by the Board under section 372A (2) and the register maintained by the company under 372A(5) of Companies Act. The auditor should also check that guarantee, in favour of certain borrowers falling in the list of persons covered in section 295(1), has been given after obtaining prior approval of Central Government.

Commercially, the guarantee could be for a single transaction or for a series of transactions or for a fixed period or for a fixed amount or a combination of these elements. The auditor should examine the following terms and conditions before coming to a judgement:

- *Urgency of borrowing*
- *Why the guarantee was given in favour of the borrower. What is the relationship between the company and the borrower? In most cases the company gives guarantee for a loan given by the bank to its subsidiary or its Tier-1 supplier, in the later case owing to its business dependency*
- *Is there a guarantee commission from the borrower at market rates for standing as a guarantor? It is noteworthy that total failure of consideration entitles the guarantor to have his guarantee delivered up and cancelled.*
- *Are repayments being made by the borrower in time as per the schedule agreed with the lending banker*
- *Is the financial health of the borrower sound as assessed by coverage, solvency and profitability ratios*
- *Is the commitment under the guarantee coming down?*

On analysis, it appears that clause will not apply in three situations: First it does not apply to situations of indemnity. Briefly, a guarantee is a collateral contract to answer for the default of another person and thus is a contract that is ancillary or subsidiary to another contract. But a contract of indemnity is one by which the indemnifier undertakes an original and independent obligation to make good and save another from loss on some obligation which he has incurred to a third person. Secondly, the clause does not refer to counter guarantees that are furnished by a company to the banker who gave the principal guarantee on behalf of the company. Thirdly, it does not apply to loans taken by others from parties other than bankers and FIs.

The ICAl in its guidance note on "Guarantees & Counter-Guarantees given by companies' has adviced that the note regarding the contingent liability should disclose both the amount of the guarantee and the amount outstanding at the balance sheet date (para 3.5).

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

The ideal thing would he for the directors to commit on this in the management discussion and analysis report and to spare the auditor in view of its complexity. Nevertheless....

There are two practices in the matter of granting term loans. In the case of small borrowers, the lending banker gives a cheque / draft directly in favour of the supplier and thus it is ensured that the term loan is utilised for the intended purpose. In the case of the big borrowers, the term loan account is credited to the cash credit account of the company either in lump sum or in instalments as per the sanction letter and the borrowed amount is utilised by the company for making payment to the supplier(s) of capital goods. The banker normally insists on a certificate from the company's auditor certifying the receipt of capital goods by the company and the incurrence of the expenditure, further followed by a certificate from the auditor once in six months till the satisfaction of loan that the capital goods remain in the ownership and possession of the company.

For the purpose of document verification, the auditor may refer to loan document, suppliers' bills, inwarding goods receipt note and installation report. He may obtain a certificate of physical verification from an outside expert by way of third party confirmation.

From the accounting perspective, as long as the value of current year additions to the relevant assets financed by the term loan is greater than the term loan as originally sanctioned i.e. considering before the repayments, the auditor may draw a conclusion that the term loan has been put to the desired purpose. It would be meaningful if the report is given in the year of utilization.

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

Trade credit is the largest source of short-term funds. Established companies sometimes borrow on a short-term basis through commercial paper and other money *market instruments. Short term, self liquidating loan (often unsecured) is a popular source, particularly in financing seasonal build ups in accounts receivable and inventories. These are extended by commercial banks under a line of credit, under a revolving credit agreement, or a transaction basis. Long term funds are procured by way of equity and preference capital, debenture capital, rupee term loans, foreign currency term loans, soft loans, deferred payments under bills rediscounting scheme, etc.*

Long-term investments are in fixed assets and strategic inter corporate investments. It is to be noted that there is no separate bank account one for short-term funds and another for long-term funds. It is a consolidated account comprising of all transactions be it purchase of inventories, assets, expenses, collection, borrowing and repayments, investments etc.

AS 3 which is a mandatory standard from 1.4.2001 for listed and certain enterprises requires reporting of cash flows classified as operating, investing and financing activities. A critical study of the cash flows will help the auditor in determining how the funds were utilised during the year. Further, on the balance sheet date, if the total value of fixed assets at cost (removing the effect of revaluation if any) and long-term investments at cost is less than the quantum of long-term funds, then it is a good financing decision. If it is more, it implies that short-term funds have been diverted to make long-term investment which is not a prudent decision. The basic principle is that long-term funds may also be utilised to finance core working capital if necessary, but short-term sources should never be deployed to meet long term needs of the business

Reporting is not an easy task. Part-l of Schedule VI of the Companies Act does not require a company to disclose the maturity profile of liabilities. In the absence of information regarding short term and long term liabilities, a fundamental question arises how it is possible for the auditor to comment under the clause. One cannot expect the auditor to sit and prepare this statement. Accordingly, Part I needs to be amended requiring the management to disclose the maturity profile as prescribed by RBl for non banking financial companies.

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

The ideal thing would be for the directors to commit on this in the Board's Report u/s 217 and not shifting it to the auditor for this may fall outside the audit syllabus (!)

Strictly, there is no basis to determine whether the price is fair. We can benefit by studying the SEBI guidelines applicable to listed companies for preferential allotments of shares, etc which states that of late, the practice of making preferential allotments of shares, etc. at a price unrelated to the prevailing market price of such instruments seem to be on the increase. This development is particularly undesirable as the allotments are made to select persons, who are considered to be the promoters, or persons for the time being in charge of the affairs of management of the company. The issue of shares on a preferential basis can be made at a price not less than the higher of the average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the six months preceding the relevant date (or) the average of the weekly high and low of the closing prices of the related shares quoted on a stock exchange during the two weeks preceding the relevant date. "Relevant date" is the date thirty days prior to the date on which the meeting of general body of shareholders is convened, in terms of section 81 (1A) of the Companies Act to consider the proposed issue.

In respect of unlisted companies, no guideline is available. Perhaps, the auditor could check whether the price is based on earning per share (EPS) linked to the Price Earning (P/E) multiple, or a price based on the Net Asset Value (NAV) linked to book value multiple, whichever is higher.

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

This provision is in the best long term interest of lenders and borrowing company. The auditor should with the help of the advocate if required examine the nature of charge, ranking of charge (i.e. first, second, pari passu etc), minimum security cover required, provision for subsequent valuation, circumstances when the security will become enforceable, preservation of assets charged as security etc. He should go through the debenture trust deed.

It would be the duty of management to prove that the company has kept the charged property / security adequately insured and paid all taxes and insurance premium with respect to the security. Incidentally, he should also satisfy that the company has created debenture redemption reserve as per SEBl Guidelines, *2000.*

It does not stand to reason why other secured loans have been excluded from purview.

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

There is a general feeling that money mobilized through public issues could get siphoned away. SEBI (Disclosure and Investor Protection) Guidelines, 2000 vide para 6.5.7.1 requires the Board of Directors to include a statement in respect of public issues in offer document on the following :

- *deposit of money in a separate bank account received out of issue of shares or debentures to the public*
- *disclosure of all monies utilized out of the above under a separate head in the balance sheet of the company indicating the purpose for which the such monies have been utilized.*
- *disclosure of all unutilized monies under a separate head in the balance sheet of the company indicating the form in which such unutilized monies have been invested. This stipulation is already forming part of Schedule VI Part I under the head 'Investments' vide clause 5.*

The auditor has to verify the disclosure with reference to documents and agreements and should he find any nonconformity, he will have to report.

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

The clause goes a long way and fulfils the expectation of the shareholders. The clause is carefully worded. It does not place responsibility on the auditor to detect fraud nor is he required to state that the financial statements are free of frands. The auditor being an unbiased and independent agency is placed under an obligation to report to the stakeholders on any fraud committed by the management or employees with or without the collusion of any third party noticed by statutory authorities or by himself or reported to statutory authorities or brought to his notice during the year. Here materiality of the amount involved in the fraud is irrelevant and the auditor would do well in bringing it in his report. The ICAI standard AAS4 titled' The Auditor's responsibility to consider fraud and error in audit of financial statements' is a boon to the profession and gives guidance on the subject. Briefly, it states that the responsibility for prevention and detection of fraud and error rests with management through adequate internal control.

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

In this context, dispassionately, today the role of the Audit committee in many companies is as laid down in Clause 49 of the listing agreement. The audit committee of the Board of Directors could review the CARO issues on quarterly basis without postponing to year end and devote their attention to Internal audit reports covering them. Their high level review would supplement the auditor's independent scrutiny and diligence in the overall interest of all stakeholders