

HELP BOOK ON REPORTING UNDER CARO, 2015 OF THE AUDITOR'S REPORT

Disclaimer:

This document contains the information compiled from the Notification issued by MCA regarding CARO 2015 and the guidance note of ICAI issued for CARO 2003 only to help the professional for filling the CARO 2015 Audit Report and it is for personal and private circulation and not bearing any opinion or advice.

Note:

All the Sections and Schedule mentioned in the comments below pertains to Companies Act, 1956 and the same has to correlate with Companies Act, 2013. The comments are taken from Guidance Note Issued by ICAI for CARO, 2003.

CARO 2015, Clause by clause comments:

Clause (i):

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

Comments:

(a) The clause requires the auditor to comment whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets. Accounting Standard (AS) 10, "Accounting for Fixed Assets" defines "fixed asset" as an "asset held with the intention of being used for the purpose of producing or providing goods or services and is not held for sale in the normal course of business".

(b) The Order is silent as to what constitutes 'proper records'. In general, however, the records relating to fixed assets should contain, inter alia, the following details:

- (i) sufficient description of the asset to make identification possible;
- (ii) classification, that is, the head under which it is shown in the accounts, e.g., plant and machinery, office equipment, etc;
- (iii) situation;
- (iv) quantity, i.e., number of units;
- (v) original cost;
- (vi) year of purchase;
- (vii) adjustment for revaluation or for any increase or decrease in cost, e.g., on revaluation of foreign exchange liabilities;
- (viii) date of revaluation, if any;
- (ix) rate(s)/basis of depreciation or amortisation, as the case may be;
- (x) depreciation/amortisation for the current year;
- (xi) accumulated depreciation/amortisation;
- (xii) particulars regarding impairment;
- (xiii) particulars regarding sale, discarding, demolition, destruction, etc.

(c) The records should contain the above-mentioned particulars in respect of all items of fixed assets, whether tangible or intangible self-financed or acquired through finance lease. These records should also contain particulars in respect of those items of fixed assets that have been fully depreciated or amortized or have been retired from active use and held for disposal. The records should also contain necessary particulars in respect of item of fixed assets that have been fully impaired during the period covered by the audit report. Thus, what constitutes proper records is a matter of professional judgment made by the auditor after considering the facts and circumstances of each case.

(d) It is necessary that the aggregate original cost, depreciation or amortization to date, and impairment loss, if any, as per these records under individual heads should tally with the figures shown in the books of account.

(e) It is not possible to specify any single form in which the records should be maintained. This would depend upon the mode of account keeping (manual or computerized), the number of operating locations, the systems of control, etc. It may be noted that with the advent of the information technology, many companies are maintaining electronic records. Section 2(1)(t) of the Information Technology Act, 2000 defines the term "electronic record" as data recorded or data generated, image or sound stored, received or sent in an electronic form or computer generated micro fiches. If the records of fixed assets are maintained electronically, they have to be maintained in a manner that they can be retrieved in a legible form (which is different from machine readable form). Records maintained using electronic media should not be construed to be proper if the records are not capable of being retrieved in a legible form. Thus, a condition for valid electronic records of fixed assets is that they can be retrieved in a legible form. The Information Technology Act, 2000, lays down legal framework for electronic records and digital signatures. Accordingly, where any law requires that any information or matter should be in the typewritten or printed form, then such requirement shall be deemed to be satisfied if it is in an electronic form. However, it will have to be ensured that the information contained in the electronic records remains accessible and unaltered and its origin, destination, date, etc., can be identified. Moreover, paragraph 34 of SA 400, "Risk Assessments and Internal Control" is also noteworthy in this regard. The paragraph states as follows:

"34. In a computer information systems environment, the objectives of tests of control do not change from those in a manual environment; however, some audit procedures may change. The auditor may find it necessary, or may prefer, to use computer Statement on the Companies (Auditor's Report) Order, 2003 CARO, 2003 assisted audit techniques. The use of such techniques, for example, file interrogation tools or audit test data, may be appropriate when the accounting and internal control systems provide no visible evidence documenting the performance of internal controls which are programmed into a computerized accounting system."

The auditor may, therefore, accept electronic fixed assets register if the following two conditions are satisfied:

- (i) The controls and security measures in the company are such that once finalized, the fixed assets register cannot be altered without proper authorization and audit trail.
- (ii) The fixed assets register is in such a form that it can be retrieved in a legible form. In other words, the emphasis is on whether it can be read on the screen or a hard copy can be taken. If this is so, one can contend that it is capable of being retrieved in a legible form.

In case the above two conditions or either of the two conditions are not satisfied, the auditor should obtain a duly authenticated print-out of the fixed assets register. In case the auditor decides to rely on electronically maintained fixed assets register, he should maintain adequate documentation evidencing the evaluation of controls that seek to ensure the completeness, accuracy and security of the register.

(f) In cases where the original cost cannot be ascertained, Schedule VI to the Act provides that the book value as at 1st April, 1956 may be considered as cost. For the limited purpose of determining whether proper records are maintained, it should be considered as sufficient if, in respect of assets acquired prior to 1st April, 1956 where the original cost cannot be ascertained, the book value as on that date is considered as the cost.

(g) Schedule XIV to the Act provides that depreciation on assets, whose actual cost does not exceed rupees five thousand, shall be provided at the rate of hundred percent. The records of fixed assets should include the necessary particulars in respect of such assets also. However, Schedule XIV to the Act further provides that where the aggregate cost of the individual items of plant and machinery costing Rs. 5000/- or less, constitutes more than 10 percent of the total actual cost of the plant and machinery, the same would have to be depreciated as per rates of depreciation provided in item II, Plant and Machinery, of the Schedule. The auditor should, therefore, examine whether the company has an appropriate mechanism in place to ensure compliance with this provision of Schedule XIV.

(h) The purpose of showing the situation of the assets is to make verification possible. There may, however, be certain classes of fixed assets whose situation keeps changing, for example, construction equipment which has to

be moved to sites. In such circumstances, it should be sufficient if record of movement/custody of the equipment is maintained.

(i) Where assets like furniture, etc., are located in the residential premises of members of the staff, the fixed assets register should indicate the name/designation of the person who has custody of the asset for the time being. In this connection, it may be necessary for the auditor to consider whether there are good reasons for the asset to be so located.

(j) While, generally, the quantity, value and situation have to be recorded item-wise, assets of small individual value, e.g., chairs, tables, etc., may be conveniently grouped for purposes of entry in the register. Similarly, for assets having a common rate of depreciation, it may not be necessary to indicate the accumulated depreciation for each item; instead, depreciation for the group as a whole may be shown.

(k) Quantitative details in respect of fixed assets may be maintained on the following lines:

(i) Land may be identified by survey numbers and by deeds of conveyance.

(ii) Leaseholds can be identified by individual leases.

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

(iv) Railway sidings can be identified by length and location.

(v) Plant and Machinery may be sub-divided into fixed and movable. For movable machinery, a separate record may be kept for each individual item. Movable machinery would include, for this purpose, items of plant which are for the moment fixed to the shop-floor but which can be moved, e.g., machine tools. In respect of fixed plant and machinery, a sub-division can be made according to the process, a plant for each separate process being considered as a separate identifiable unit. A further sub-division may be useful when within a process, there are plants which are capable of working independently of each other. The degree to which a sub-division of fixed plant and machinery should be made depends upon the circumstances of each case bearing in mind the twin objectives of sub-division, namely, the determination of individual cost and the facility for physical verification.

(vi) The Act does not require electrical installations to be shown as a separate asset though a number of companies do so in fact. For purposes of identification, however, it is suggested that the initial sub-division may be made according to the user, e.g., factory buildings, plant, service departments, township buildings, etc. A further sub-division can be made according to the sub-division already made for buildings, plant, etc.

(vii) Furniture and fittings and assets like office appliances, air-conditioners, water coolers, etc., consist of individual items which can be easily identified. Some difficulty may, however, be faced with regard to the large number of items and their relative mobility. In such cases, a distinction by value may be necessary, individual identification being made for high-value items and by groups for other items.

(viii) Development of property is an asset head which can be easily sub-divided according to the buildings or plant for which the development work is undertaken.

(ix) Patents, trademarks and designs are normally identifiable by the purchase agreements or the letters granting patent and by registration references in case of trademarks and designs.

(x) Vehicles can be identified by reference to the registration books.

(xi) Intangible assets can be identified by reference to the purchase agreements (in case an intangible asset has been purchased) and by reference to the records and documents that substantiate the costs incurred by the company in the generation and development of an intangible asset.

(l) In cases where the details regarding allocation of cost over identified units of assets are not available, it would have to be made by an analysis of the purchases and the disposals of the preceding years. Among the difficulties which may be faced could be: (i) records for some of the years may not be available; (ii) the description in the records may not be complete; (iii) details of disposals may not have been properly recorded; (iv) subsequent additions to an existing asset may have been shown as a separate asset; (v) a single figure of cost may be assigned to a number of assets which have to be separately identified; (vi) assets purchased for one department may have been moved to other departments, and so on. The management, in consultation with the auditor, should make the best effort possible under the circumstances to identify the cost of each asset. In doing so, reasonable assumptions or approximations may be made, where necessary. For example, when details of disposals are not available, it may be assumed that the asset sold is the asset which was acquired earliest in point of time. Similarly, when the individual cost of a large number of small items is not available, one can estimate the cost of each item and pro-rate the total cost in the proportion of the estimated cost of the item to the aggregate estimated cost.

(m) It may be useful if initial identification of assets is done by persons who are familiar with them, e.g., the maintenance staff. At the point of identification, a code number may be affixed on the asset which would give sufficient details for future identification.

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

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

Comments:

(a) The clause requires the auditor to comment whether the fixed assets of the company have been physically verified by the management at reasonable intervals. The clause further requires the auditor to comment whether any material discrepancies were noticed on such verification and if so, whether those discrepancies have been properly dealt with in the books of account.

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

making this examination, it is necessary to ensure that the person making the verification had the necessary technical knowledge where such knowledge is required. It is not necessary that only the company's staff should make verification. It is also possible for verification to be made by outside expert agencies engaged by the management for the purpose.

(c) The auditor should examine whether the method of verification was reasonable in the circumstances relating to each asset. For example, in the case of certain process industries, verification by direct physical check may not be possible in the case of assets which are in continuous use or which are concealed within larger units. It would not be realistic to expect the management to suspend manufacturing operations merely to conduct a physical verification of the fixed assets, unless there are compelling reasons which would justify such an extreme procedure. In such cases, indirect evidence of the existence of the assets may suffice. For example, the very fact that an oil refinery is producing at normal levels of efficiency may be sufficient to indicate the existence of the various process units even where each such unit cannot be verified by physical or visual inspection. It may not be necessary to verify assets like building by measurement except where there is evidence of alteration/demolition. At the same time, in view of the possibility of encroachment, adverse possession, etc., it may be necessary for a survey to be made periodically of open land.

(d) It is advisable that the assets are marked with "distinctive numbers" especially where assets are movable in nature and where verification of all assets is not being conducted at the same time.

(e) The Order requires the auditor to report whether the management "at reasonable intervals" has verified the fixed assets. What constitutes "reasonable intervals" depends upon the circumstances of each case. The factors to be taken into consideration in this regard include the number of assets, the nature of assets, the relative value of assets, difficulty in verification, situation and spread of the assets, etc. The management may decide about the periodicity of physical verification of fixed assets considering the above factors. While an annual verification may be reasonable, it may be impracticable to carry out the same in some cases. Even in such cases, the verification programme should be such that all assets are verified at least once in every three years. Where verification of all assets is not made during the year, it will be necessary for the auditor to report that fact, but if he is satisfied regarding the frequency of verification he should also make a suitable comment to that effect.

(f) The auditor is required to state whether any material discrepancies were noticed on verification and, if so, whether the same have been properly dealt with in the books of account. The latter part of the statement is required to be made only if the discrepancies are material. The auditor has, therefore, to use his judgement to determine whether a discrepancy is material or not. In making this judgement, the auditor should consider not merely the cost of the asset and its relationship to the total cost of all assets but also the nature of the asset, its situation and other relevant factors. If a material discrepancy has been properly dealt with in the books of account (which may or may not imply a separate disclosure in the accounts depending on the circumstances of the case), it is not necessary for the auditor to give details of the discrepancy or of its treatment in the accounts but he is required to make a statement that a material discrepancy was noticed on the verification of fixed assets and that the same has been properly dealt with in the books of account.

(g) Apart from the audit procedures mentioned above, it would be appropriate for the auditor to obtain a management representation letter confirming that the fixed assets are physically verified by the company in accordance with the policy of the company. The management representation letter should also mention the periodicity of the physical verification of fixed assets. The letter should also include the details of the material discrepancies noticed during the physical verification of the fixed assets. If no discrepancies were noticed during the physical verification, the management representation letter should also mention this fact clearly.

Clause (ii):

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

Comments:

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

"Inventories are assets:

(a) held for sale in the ordinary course of business;

(b) in the process of production for such sale; or

(c) in the form of materials or supplies to be consumed in the production process or in the rendering of services."

(b) Inventories encompass goods purchased and held for resale, for example, merchandise purchased by a retailer and held for resale, computer software held for resale, or land and other property held for resale. Inventories also encompass finished goods produced, or work in progress being produced, by the enterprise and include materials, maintenance supplies, stores and spares, consumables and loose tools awaiting use in the production process. It may be noted that packing materials are also included in inventories. Inventories do not include machinery spares covered by Accounting Standard (AS) 10, "Accounting for Fixed Assets", which can be used only in connection with an item of fixed asset and the use of which is expected to be irregular.

(c) Physical verification of inventory is the responsibility of the management of the company which should verify all material items at least once in a year and more often in appropriate cases. It is, however, necessary that the auditor satisfies himself that the physical verification of inventories has been conducted at reasonable intervals by the management and that there is adequate evidence on the basis of which the auditor can arrive at such a conclusion. For example, the auditor may examine the documents relating to physical verification conducted by the management during the year as also at the end of the financial year covered by the auditor's report.

(d) What constitutes "reasonable intervals" depends on circumstances of each case. The periodicity of the physical verification of inventories depends upon the nature of inventories, their location and the feasibility of conducting a physical verification. The management of a company normally determines the periodicity of the physical verification of inventories considering these factors. Normally, wherever practicable, all the items of inventories should be verified by the management of the company at least once in a year. It may be useful for the company to determine the frequency of verification by 'A-B-C' classification of inventories, 'A' category items being verified more frequently than 'B' category and the latter more frequently than 'C' category items.

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

Comments:

(a) This clause requires the auditor to comment on the reasonableness and adequacy of the inventory verification procedures followed by the management of the company. In case the procedures of physical verification of inventories, in the opinion of the auditor, are not reasonable and adequate in relation to the size of the company and the nature of its business, the auditor has to report the same. The term "inventory" should be construed to have the same meaning as assigned to it in Accounting Standard (AS) 2, "Valuation of Inventories".

(b) An auditor should obtain reasonable assurance about existence and condition of inventories. Observation of physical verification/ examination of records of verification inventory are the primary source of evidence for the purpose of reporting under this clause. While the physical verification of inventories is primarily the duty of the management, the auditor is expected to examine the methods and procedures of such verification. The auditor may, if considered appropriate by him, be also present at the time of stock-taking. The duties and responsibilities

of the auditor while attending a stock taking by the management are governed by the principles laid down in the Standard on Auditing (SA) 501, "Audit Evidence – Additional Considerations for Specific Items", issued by the Institute of Chartered Accountants of India. The auditor should establish the reasonableness and adequacy of procedures adopted for physical verification of inventories having regard to the nature of inventories, their locations, quantities and feasibility of conducting the physical verification. This would require the auditor to make use of his professional judgement.

(c) There are two principal methods of physical verification of inventories: periodic and continuous. Under the periodic physical verification method, physical verification of inventories is carried out at a single point of time, usually at the year-end or at a selected date just prior to or shortly after the year-end. Under the continuous physical verification method, physical verification is carried out throughout the year, with different items of inventory being physically verified at different points of time. However, the verification programme is normally so designed that each material item is physically verified at least once in a year and more often in appropriate cases. The continuous physical verification method is effective when a perpetual inventory system of record-keeping is also in existence. Some entities use continuous physical verification methods for certain stocks and carry out a full count of other stocks at a selected date.

(d) Normally, before commencement of verification, the management should issue appropriate instructions to stock-taking personnel. Such instructions should cover all phases of physical verification and preferably be in writing. It would be useful if the instructions are formulated by the entity in consultation with the auditor. The auditor should examine these instructions to assess their efficacy. The auditor while forming his opinion, in addition to finding answers to the illustrative questions for evaluating the internal controls mentioned in the Appendix IX of the Statement, employs several audit procedures, including examination of the reports of the internal auditor. The auditor has to use his professional judgement regarding the nature, timing and extent of the procedures to be applied in forming his opinion for commenting on this clause. The auditor can rely upon the work of an internal auditor provided the auditor complies with the requirements of Standard on Auditing (SA) 610, "Relying Upon the Work of an Internal Auditor", issued by the Institute of Chartered Accountants of India.

(e) The auditor should ascertain whether the management has instituted adequate cut-off procedures. For example, he may examine a sample of documents evidencing the movement of inventories into and out of stores, including documents pertaining to periods shortly before and shortly after the cut-off date, and check whether the inventories represented by those documents were included or excluded, as appropriate, during the stock-taking.

(f) The auditor should review the original physical verification sheets and trace selected items - including the more valuable ones - into the final inventories. He should also compare the final inventories with stock records and other corroborative evidence, e.g., inventory statements submitted to banks.

(g) Where continuous stock-taking methods are being used by the entity, the auditor should, in addition to performing the audit procedures discussed above, pay greater attention to ascertaining whether the management:

(i) maintains adequate stock records that are kept up-to-date;

(ii) has established adequate procedures for physical verification of inventories, so that in the normal circumstances, the programme of physical verification will cover all material items of inventory at least once during the year; and

(iii) Investigates and corrects all material differences between the book records and the physical counts.

(h) The auditor should determine whether the procedures for identifying damaged and obsolete items of inventory operate properly.

(i) The auditor may determine the reasonableness and adequacy of the procedures of physical verification of inventories by examining the related records and documents. These records and documents would also include the policy of the company regarding physical verification. The following are the documents which can be examined by the auditor in this regard:

(i) written instructions given by the management to the concerned staff engaged in the verification process;

- (ii) physical verification inventory sheets duly authenticated by the field staff and responsible officials of the company;
- (iii) summary sheets/consolidation sheets duly authenticated by the responsible officials;
- (iv) internal memos etc., with respect to the issues arising out of physical verification of inventory;
- (v) any other relevant documents evidencing physical verification of inventory.

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

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

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

Comments:

(a) The clause requires the auditor to comment whether the company is maintaining proper records of inventory. The clause also requires the auditor to comment whether any material discrepancies were noticed on physical verification of inventory and if so, whether those material discrepancies have been properly dealt with in the books of account.

(b) What constitutes "proper records" has not been defined. However, in general, records relating to inventories should contain, inter alia, the following:

- (i) particulars of the item like nomenclature, nature, etc.
- (ii) identification code of the item;
- (iii) details regarding quantity of the receipts, issues, balances and dates of transactions in a chronological manner;
- (iv) relevant document number and department identification, if any;
- (v) location.

(c) If priced stores ledger is maintained, the records of the inventory should also disclose the prices at which the recording of the issues and receipts is made.

(d) The records should contain the particulars in respect of all items of inventories. The auditor should also satisfy himself that the stock registers are updated as and when the transactions occur. The auditor should also verify that the transactions entered in stock registers are duly supported by relevant documents.

(e) The purpose of showing the location of the inventory is to make verification possible. The record of movement/custody of the inventory should be maintained.

(f) In cases where a company is maintaining stock records for work-in-progress, say, for compliance with the requirements of the section 209(1)(d) of the Companies Act, 1956, the auditor would normally be able to obtain relevant information in respect of work-in-progress from such records. However, in many cases, it might be impracticable to maintain stock records for work-in-progress. In such cases, the auditor should consider the fact whether the company, at any point of time, can arrive or calculate the quantity and amount involved in the work-in-progress. Some of the factors that might be used in arriving at the value of work in progress include the

production cycle, input/ output ratio analysis, production and stock records for the immediately following period. If the company is able to do so, the auditor may form an opinion that proper records relating to the work-in-progress have been kept and, accordingly, no adverse comment of the auditor under this clause would be required. However, before adopting this as an audit procedure, the auditor should satisfy himself as to the impracticability of maintenance of stock registers of work-in-progress.

(g) It is not possible to specify any single form in which the records should be maintained. This would depend upon the mode of account-keeping (manual or computerized), the number of operating locations, the systems of control, etc.

(h) The Order further requires the auditor to examine whether material discrepancies have been noticed on verification of inventories when compared with book records. Such an examination is possible when quantitative records are maintained for inventories but in many cases circumstances may warrant that records of individual issues (particularly for stores items) are not separately maintained and the closing inventory is established only on the basis of a year-end physical verification. Where such day-to-day records are not maintained, the auditor will not be able to arrive at book inventories except on the basis of an annual reconciliation of opening inventory, purchases and consumption. This reconciliation is possible when consumption in units can be co-related to the production, or can be established with reasonable accuracy. Where such reconciliation is not possible, the auditor would be unable to determine the discrepancies. If the item for which the discrepancy cannot be established is not material, the discrepancy, if any, will also not be material. For example, an item categorised as 'C' in ABC analysis might not be material and therefore, the discrepancy, if any, in regard to such an item would not be material. In other cases, however, the auditor will have to report that he is unable to determine the discrepancy, if any, on physical verification for the item or class of items to be specified.

Clause (iii): Whether the company has granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 189 of the Companies Act. If so,

Comments:

(a) There are seven clauses under paragraph 4(iii) of the Order. It is clarified that the auditor's comments on all the seven clauses are to be made with reference to the companies, firms or other parties covered in the register maintained under section 301 of the Act.

(b) The duty of the auditor, under this clause, is to determine 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 Act. If the company has done so, the clause requires that the auditor's report should disclose the "number of parties" and "amount involved" in such cases. The auditor is required to disclose the requisite information in his report in respect of all parties covered in the register maintained under section 301 of the Act irrespective of the period to which such loan relates. The clause covers not only the loan granted during the year but covers all loans including opening balances. Further, there is no stipulation regarding the loan being given in cash or in kind. In the absence of such stipulation, the auditor is required to disclose the requisite information in his report in respect of all kind of loans whether given in cash or in kind to the parties covered in the register maintained under section 301 of the Act.

(c) Under section 301 of the Act, every company is required to maintain one or more registers which contain the particulars of all contracts or arrangements to which section 297 or section 299 of the Act applies. The particulars of contracts and arrangements required to be entered in the register maintained under section 301 include, among other things, names of the parties to the contract or arrangement. It is, however, suggested that the auditor should acquaint himself with all the requirements of sections 297, 299 and 301 of the Act. Text of sections 297, 299 and 301 is reproduced in Appendix X to the Statement.

(d) The auditor should obtain a list of companies, firms or other parties covered in the register maintained under section 301 of the Act from the management. The auditor should examine all loans (secured or unsecured) granted by the company to identify those loans granted to companies, firms or other parties covered in the register maintained under section 301 of the Act.

(e) It may so happen that a party listed in the register maintained under section 301 of the Act might take a loan from the company and repays it to the company during the financial year concerned. Therefore, while examining the loans, the auditor should also take into consideration the loan transactions that have been squared-up during the year and report such transactions under the clause. For example, the company has, during the financial year, granted a loan of Rs. 1,00,000/- to a firm in which one of the directors of the company is interested and the firm repays the loan during the financial year concerned. The auditor is also required to consider such transaction while commenting upon this clause of the Order.

(f) Apart from reporting the number of parties, the auditor is also required to disclose the “amounts involved”. Since the Order does not clarify what constitutes “amounts involved” it would be proper if the auditor discloses the maximum amount involved during the year in the transactions covered by this clause. While commenting upon this clause, the auditor may also consider whether the year-end balance should also be disclosed in his audit report.

(a) Whether receipt of the principal amount and interest accrued also regular; and

Comments:

(a) This part of the clause requires the auditor to report upon the regularity of receipt of principal amount of loans and interest thereon. Again, read with paragraphs 4(iii)(a) and (b) of the Order, the scope of auditor's inquiry under this clause shall be restricted in respect of companies, firms or other parties covered in the register maintained under section 301 of the Act. The auditor is required to comment on this clause in regard to receipt of principal amount of loans “granted” by the company to companies, firms or other parties covered in the register maintained under section 301 of the Act.

(b) The auditor has to examine whether the receipt of principal amount and interest is regular. The word ‘regular’ should be taken to mean that the principal and interest should normally be received whenever they fall due, respectively. If a due date for receipt of interest is not specified, it would be reasonable to assume that it falls due annually. A loan repayable on demand falls due as and when the lender calls back the loan. The auditor can make an assessment of the regularity only if the loan is demanded by the company since the question of regularity would be judged by consequent action of the company (payment or non-payment). If the lending company has not called back the loan, the auditor cannot comment under this sub-clause.

(c) The following are some of the procedures that the auditor may apply to report on the clause:

- (i) the auditor, while obtaining an understanding of the terms and conditions for reporting under paragraph 4(iii)(b) of the Order, should also take note of repayment schedule;
- (ii) if loan agreements are not executed, any other equivalent documents may be referred to arrive at the terms of receipt of interest, for example, letters of understanding, acknowledgement by the party of the terms and conditions communicated by the company, etc.;
- (iii) the dates of receipt of principal amount and payment of interest needs to be verified with reference to the books of accounts of the company to come to the conclusion whether such receipts are regular; and
- (iv) if the results of the procedures mentioned above indicate any irregularity in receipt of principal and/or interest, the auditor should mention the fact in his report.

(d) In case where the auditee company is a non-banking finance company, the auditor, for reporting under this clause, would also need to refer to the policy for demand/ call loans framed under clause 6A of the NBFCs Prudential Norms (RBI Directions), 1998 issued by the Reserve Bank of India. The text of clause 6A of the Regulations is given in Appendix X to the Statement.

(e) Where no stipulation has been made for the recovery of the loan, the auditor is not in a position to make any specific comments. However, the auditor should state the fact that he has not made any comments because the terms of recovery have not been stipulated.

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

Comments:

(a) This clause requires the auditor to state whether reasonable steps have been taken by the company for recovery of the principal and interest, wherever the overdue amount is more than rupees one lakh. A loan is considered to be overdue when the payment has not been received on the due date as per the lending arrangements. In such cases, the auditor has to examine the steps, if any, taken for recovery of this amount. It may, however, be noted that the scope of the auditor's inquiry under this clause is restricted to loans given by the company to parties covered in the register maintained under section 301 of the Act.

(b) In making this examination, the auditor would have to consider the facts and circumstances of each case, including the amounts involved. It is not necessary that steps to be taken must necessarily be legal steps. Depending upon the circumstances, the degree of delay in recovery and other similar factors, issue of reminders or the sending of an advocate's or solicitor's notice, may amount to "reasonable steps" even though no legal action is taken. The auditor is not, therefore, required to comment adversely on the mere absence of legal steps if he is otherwise satisfied that reasonable steps have been taken by the company. The auditor should ask the management to give in writing, the steps which have been taken. The auditor should arrive at his opinion only after consideration of the management's representations.

(c) The auditor should obtain sufficient appropriate audit evidence to support the fact that reasonable steps have been taken for recovery of the principal and interest of loans taken/granted by the company.

Clause (IV): Is there an adequate internal control system 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 and services. Whether there is a continuing failure to correct major weaknesses in internal control system?

Comments:

(a) The clause requires the auditor to comment whether there is an adequate internal control system commensurate with the size of the company and the nature of its business, for the purchase of inventory, fixed assets and sale of goods and services. Further, the clause also requires the auditor to report whether there is a continuing failure by the company to correct major weaknesses in the internal control system in regard to purchase of inventory, fixed assets and the sale of goods and services.

(b) Obtaining an understanding of internal control systems is a normal audit procedure. While the requirement of the Order is confined only to internal control procedures regarding purchase of inventory, fixed assets and sale of goods and services, it does not mean that the duty of the auditor to examine internal control with regard to other areas is in any way diminished. It only means that special emphasis has to be given by the auditor on internal control system with regard to the items specified in the clause as aforesaid.

(c) "Internal Control System" means all the policies and procedures (internal controls) adopted by the management of an entity to assist in achieving management's objective of ensuring, as far as practicable, the orderly and efficient conduct of its business, including adherence to management policies, the safeguarding of assets, prevention and detection of frauds and errors, the accuracy and completeness of the accounting records, and the timely preparation of reliable financial information.

(d) Different techniques may be used to document information relating to internal control systems. Selection of a particular technique is a matter of auditor's judgement. Common techniques, used alone or in combination, are narrative descriptions, flow-charts, questionnaires, check lists, etc. Use of any one of these methods does not preclude the use of the other and the auditor is free to select any one or more of the methods that he considers best suited to the circumstances of the case. Irrespective of the method selected, it is necessary that the auditor maintains sufficient documentation regarding his study and evaluation of the internal control system. Further, in a computer information systems environment, the auditor may find it necessary, or may prefer, to use computer assisted audit techniques, for example, file interrogation tools or audit test data, may be appropriate when the accounting and internal control systems provide no visible evidence for evaluating the internal controls which are

programmed into a computerised accounting system. In this regard, attention is invited to the Standard on Auditing (SA) 400, "Risk Assessments and Internal Control" issued by the Institute.

(e) In making the evaluation, the auditor has to give due regard not merely to the size of the company and the nature of its business but also to the organisational structure. This suggests that whereas detailed internal control procedures may be absolutely essential for a large company with a diversified business operating at several locations, internal control may be less formal in an "owner-managed" or a small company where there is a greater degree of personal supervision. Reference in this regard may also be made to paragraph 49 of the Standard on Auditing (SA) 400, "Risk Assessments and Internal Control".

(f) An illustrative questionnaire which may be used by the auditor in evaluating the internal controls in regard to purchase of inventory, fixed assets and sale of goods is given in Appendix IX.

(g) The clause also requires the auditor to comment whether there is a continuing failure to correct major weaknesses in internal control system. The auditor, for reporting on this clause, would have to ascertain the weaknesses in the internal controls in regard to purchase of inventory, fixed assets and sale of goods and services and then examine whether there is a continuing failure to correct major weaknesses in internal controls.

(h) What constitutes "major weakness" depends upon the facts and circumstances of each case. The auditor should exercise his professional judgement in this regard. Ordinarily, any weakness in the internal controls that exposes the company to a risk of significant loss or the risk of a material misstatement in the financial statements may be considered as a major weakness and therefore, may come within the ambit of reporting under this clause. The auditor should, however, recognise that some weaknesses are of such nature that individually they may not seem to be "major" but when evaluated along with others might become relevant for the auditor while commenting upon this clause of the Order.

(i) The auditor should review the reports of internal auditor, if any. The reports of internal auditors may point out cases of weaknesses in the design of internal controls and nonobservance of the laid down controls. The auditor should also review the minutes of the meetings of the board of directors and audit committee, if any, with a view to determine the cases of weaknesses in internal controls. The auditor may come across situations where a weakness in internal control system has been placed before the board of directors or the audit committee but the same has not been considered. Such cases may point out the instances where there is a continuing failure to correct a major weakness in internal control system. The auditor should also review his previous years' working papers to determine the weaknesses in the internal control system, if any, already communicated to the management.

(j) It may be noted that paragraph 50 of Standard on Auditing (SA) 400, "Risk Assessments and Internal Control" requires that the auditor should make management aware, as soon as practical and at an appropriate level of responsibility, of material weaknesses in the design or operation of the accounting and internal control systems, which have come to the auditor's attention during the course of the audit. The auditor should examine the follow-up actions taken by the management in response to weaknesses communicated to the management. However, determination of continuing failure in correcting major weaknesses in internal controls is required to be done by the auditor and commented upon by him in his report irrespective of the existence of the internal audit function.

(k) The auditor while making an evaluation of the internal controls in regard to purchase of inventory, fixed assets and sale of goods and services while carrying out the procedures mentioned at (i) above might come across a weakness in those internal controls. The auditor should, in such circumstances, exercise his professional judgement to determine whether the weakness noted by him is a major weakness in the internal control. The auditor while commenting on the clause, makes an assessment whether the major weakness noted by him has been corrected by the management as at the balance sheet date. If the auditor is of the opinion that the weakness has not been corrected, then the auditor should report the fact while commenting upon the clause. Apart from stating that there has been a continuing failure to correct major weakness, the auditor should report the weakness and the steps taken by the management to correct the weakness, if any. Where the management has not taken any steps for correcting the weakness, the auditor's report should also state this fact. It may also happen that the weakness is corrected by the date on which the auditor issues the audit report. In such a case,

the auditor's report should state the fact that although as at the balance sheet date, there was a continuing failure to correct a major weakness on the date of the financial statements; the weakness has been corrected by the date the auditor issued his report. It may, however, be noted that the existence of continuing failure is important for reporting on this clause. Even if the management has taken reasonable steps to correct the weakness but the weakness continues, the auditor is required to report the same under this clause.

(l) In case there is a continuing failure on the part of the company to correct major weakness in the internal control system, the auditor should also make a re-assessment of the control risk, at the assertion level, for each material account balance or class of transactions related to purchase of inventory, fixed assets and sale of goods and services so that appropriate audit procedures can be designed to reduce the overall risk to an acceptably low level. Further, if the auditor is of the opinion that the major weaknesses in the internal control system have serious implications on the adequacy or reliability of the books of account of the company, the auditor should consider modifying his audit report on the financial statements. Where the auditor decides to do so, he should comply with the requirements of the Standard on Auditing (SA) 700, "The Auditor's Report on the Financial Statements" in this regard.

(m) It is also important to understand that the requirements in regard to adequacy of internal controls and continuing failure to correct major weakness (es) is not inter related. These are two distinct aspects of the clause. The first requires the auditor to comment on the adequacy of the internal controls in regard to purchase of inventories, purchase of fixed assets and sale of goods and services whereas the second aspect requires the auditor to comment whether there was a continuing failure to correct a major weakness in such internal controls. Since these two aspects are not related to each other, it cannot be concluded that if no major weakness was reported during the period covered by the audit report, the internal control system is adequate.

Clause (V): In case the company has accepted deposits, whether the directives issued by the Reserve Bank of India and the provisions of sections 73 to 76 or any other relevant provisions of the Companies Act and the rules framed there under, where applicable, have been complied with? If not, the nature of contraventions should be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any court or any other tribunal, whether the same has been complied with or not?

Comments:

(a) The clause, in addition to requiring the auditors to report on compliance with the requirements of section 58A and the directives of the Reserve Bank of India for acceptance of public deposits, also requires the auditor to:

- (i) report on compliance with the provisions of section 58AA of the Act; and
- (ii) report on compliance with the order, if any, passed by the Company Law Board or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal.

(b) Section 58A of the Act empowers the Central Government to prescribe, in consultation with the Reserve Bank of India, the limits up to which, the manner in which and the conditions subject to which deposits may be invited or accepted by a company either from the public or from its members. The section does not apply to a banking company or to such other company as the Central Government may, after consultation with the Reserve Bank of India, specify in that behalf.

(c) On 3rd February 1975, the Central Government issued the Companies (Acceptance of Deposits) Rules, 1975. The Rules apply only to such companies as are not banking companies and are also not financial companies. Thus, financial companies are not covered by the Rules. Such companies continue to be governed by the directives issued by the Reserve Bank of India.

(d) The Rules cover the following main items:

- (i) the nature of deposits which may be accepted and the terms thereof;
- (ii) the limits up to which the deposits can be accepted;
- (iii) the form and particulars of advertisement for deposits;
- (iv) the form of application for deposits;
- (v) furnishing of receipts to depositors;

- (vi) maintenance of register(s) of depositors;
- (vii) general provisions regarding the repayment of deposits and payment of interest;
- (viii) the returns to be filed with the Registrar of Companies and the Reserve Bank of India.

(e) Section 58AA was inserted by the Companies (Amendment) Act, 2000 with effect from 13th December 2000. The section deals with small depositors. According to the section, a small depositor is a depositor who has deposited in a financial year, a sum not exceeding twenty thousand rupees in a company and includes his successors, nominees, and legal representatives. The section lays down certain requirements to be complied with by the companies which have accepted deposits from such small depositors. Audit considerations similar to those that have been mentioned for section 58A would apply in regard to section 58AA also.

(f) The auditor should plan to test for compliance with the provisions of sections 58A, 58AA of the Act and the Rules made under section 58A. For such purpose, the auditor should also obtain an understanding of the requirements of sections 58A and 58AA and those of the relevant rules. Thereafter, the auditor should ascertain how the company is complying with the provisions of sections 58A, 58AA and the Rules made under section 58A.

(g) The auditor should examine compliance by the company with regard to all the matters specified in the sections and the Rules and not merely to the limits of the deposits. Where the number of deposits is very large, it is obviously not feasible for the auditor to satisfy himself that every single deposit complies with the rules. He should, therefore, examine the system by which deposits are accepted and records are maintained and make a reasonable test check to ensure the correctness of the system. The auditor may also make a “check list” to ensure that all the requirements of the Rules regarding the records to be maintained, returns to be filed, etc., are complied with.

(h) The auditor should examine the efficacy of the internal controls instituted by the company so that the deposits accepted by the company remain within the limits. It may be difficult for the auditor to ascertain that deposits accepted by the company are within the limits on each day of the accounting year. He would, therefore, be justified in making a reasonable test check to ensure that the company has not accepted deposits during the year in excess of the limits. For financial companies, the auditor should make a similar examination having regard to the Reserve Bank directives in force from time to time. In this connection, attention is invited to section 45MA of the Reserve Bank of India Act, 1934. The section is reproduced in Appendix X to the Statement.

(i) Non-compliance of section 58AA would occur in the event when a company fails to intimate the Company Law Board any default in repayment of deposit made by small depositors or part thereof or any interest thereupon. The auditor has to, therefore, first determine whether there is a default in any repayment of such deposits. This would require the auditor to examine all the accounts related to small depositors. In case where a company has large number of deposits accepted from small depositors, it may not be feasible for the auditor to first verify each account for default in repayment and then check whether the company has complied with the requirements of section 58AA of the Act. The auditor, in such a case, should examine the internal control in place in this regard and determine its efficacy. The auditor should obtain a schedule of repayment of loans taken from small depositors from the management of the company. The auditor, thereafter, should make reasonable test checks of the repayments made by the company. In case the results of the test check reveal that the management has defaulted in repayment of deposits made by small depositors or part thereof or interest thereupon, the auditor should examine whether the same has been intimated to the Company Law Board.

(j) Apart from the audit procedures mentioned above, the auditor should also enquire of the management about the possible instances of non-compliance with sections 58A, 58AA or any other relevant provisions of the Act and the relevant rules. The auditor should also enquire the management about any order passed by the Company Law Board or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal for contravention of sections 58A, 58AA or any other relevant provision(s) of the Act and the relevant rules. The auditor should obtain a management representation to the effect whether:

- (a) the company has complied with the directives issued by the Reserve Bank of India and the provision of section 58A and 58AA of the Act and the relevant rules; and
- (b) where an order has been passed by any of the relevant authorities mentioned in the clause, the company has complied with the requirements of the Order.

(k) In case where the auditor is of the view that any kind of contravention of sections 58A and 58AA or any other relevant provisions of the Act or relevant rules, has taken place, the auditor should state in his report that the provisions of section(s) 58A and/or 58AA and/or relevant rules, as the case may be, have not been complied with. The auditor should also report the nature of contraventions in case the company has not complied with the relevant directives of the Reserve Bank of India or the provisions of section 58A or with the provisions of section 58AA of the Act and the relevant rules.

(l) The auditor, under this clause, is required to verify whether the company has complied with the order passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal. Where any of such authorities has passed an order, the auditor should examine the steps taken by the company to comply with the said order. If the company has not complied with the order, the same is to be reported stating therein the nature of contravention and the fact that the company has not complied with the order issued by the Company Law Board or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal.

Clause (VI): Where maintenance of cost records has been specified by the Central Government under sub-section (1) of section 148 of the Companies Act, whether such accounts and records have been made and maintained?

Comments:

(a) Section 209 (1) (d) of the Act requires a company pertaining to a class of companies engaged in production, processing, manufacturing or mining activities to maintain proper books of account showing particulars relating to utilization of material or labour or to other items of cost as may be prescribed, if the Central Government requires such class of companies to maintain such records. Pursuant to this requirement and in exercise of the powers conferred by sub-section (1) of section 642 of the Act, the Central Government has made rules in respect of a number of classes of companies. These books of account and records form part of the books of account of the company within the meaning of section 209. A list of classes of companies in respect of which maintenance of cost records under section 209(1)(d) has been prescribed up to September 29, 2004, is given in Appendix XI.

(b) The Cost Accounting Records Rules issued for various industries contain requirements relating to two matters:

- (i) maintenance of proper books of account relating to materials, labour, and other items of cost; and
- (ii) preparation of cost statements at the end of the financial year in accordance with the rules specific to the industry concerned.

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

(c) Section 233B of the Act provides that where, in the opinion of the Central Government, it is necessary to do so in relation to any company required by section 209(1)(d) to maintain the particulars prescribed under that section, it may order an audit to be conducted of its cost accounts.

(d) It will be noticed that while a cost audit can be done only in respect of companies governed by the Rules made under section 209(1)(d), cost audit is not necessary in respect of every company which is required to maintain cost records.

(e) The Order requires the auditor to report whether cost accounts and records have been made and maintained. The word “made” applies in respect of cost accounts (or cost statements) and the word “maintained” applies in respect of cost records relating to materials, labour, overheads, etc. The auditor has to report under the clause irrespective of whether a cost audit has been ordered by the Central Government. The auditor should obtain a written representation from the management stating (a) whether cost records are required to be maintained for any product(s) of the company under section 209(1)(d); and (b) whether cost accounts and records are being made and maintained regularly. The auditor should also obtain a list of books/records made and maintained in this regard. The Order does not require a detailed examination of such records. The auditor should, therefore,

conduct a general review of the cost records to ensure that the records as prescribed are made and maintained. He should, of course, make such reference to the records as is necessary for the purposes of his audit.

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

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

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

Clause (VII):

(a) is the company regular in depositing undisputed statutory dues including provident fund, employees' state insurance, income-tax, sales-tax, wealth tax, service tax, duty of customs, duty of excise, value added tax, 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.

Comments:

(a) This clause requires the auditor 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.

(b) It may be noted that the use of the words “any other statutory dues” indicates that the clause covers all type of dues under various statutes which may be applicable to a company having regard to its nature of business. Apart from the statutory dues listed, the auditor is required to report on the regularity of the company in depositing “any other statutory dues” payable by the company to appropriate authorities under the statutes applicable to the company.

(c) The intention of the Government, in this clause is to ascertain how regular the company is in depositing statutory dues with the appropriate authorities. Since the emphasis of the clause is on the regularity, the scope of auditor's inquiry is restricted to only those statutory dues, which the company is required to deposit regularly to an authority. The auditor is not required to ascertain whether the company is regular in depositing amounts, which may be levied by an appropriate authority from time to time upon occurrence or non-occurrence of certain events and therefore are not required to be paid regularly. Any sum, which is to be regularly paid to an appropriate authority under a statute (whether Central, State or Local or foreign) applicable to the company, should be considered as a “statutory due” for the purpose of this clause. In other words, obligation to pay a statutory due is created or arises out of a statute, rather than being based on an independent contractual or legal relationship. Thus, examples of “statutory dues” would include municipal taxes, taxes deducted at source, fees payable to the licensing authority in respect of business being carried on under license granted by an authority, say a cinema hall. Accordingly, any sum payable to an electricity company as electricity bill would not constitute a statutory due despite the fact that such a company has been established under a statute. This is so because the due has arisen on account of contract of supply of goods or services between the parties. However, care shall have to be taken that in case any dues are recoverable as arrears of land revenue by the concerned authority, the same shall be treated as a statutory due.

(d) With reference to regularity, it is also important to distinguish amongst the various items stated in the clause. The auditor should very clearly understand the nature of each statutory due payable by the company while examining the aspect of regularity before commenting on the same. For instance, the regularity is a normal feature in case of certain statutory dues such as, provident fund, employees' state insurance, sales tax, etc., because the companies are required to deposit the money with appropriate authorities on a monthly or quarterly basis. But this is not the case in respect of, say, 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 instalments, if any, granted by an authority in respect of a demand against the company.

(e) An important issue to consider is the question of regularity of payment of import duty where the goods had been imported, say, five years back and were placed in the bonded warehouse and even till the end of the financial year under audit, the goods have not been removed from such warehouse. It may be noted that when the imported goods are lodged in a bonded warehouse, the payment of import duty is to be made when the goods are removed from the bonded warehouse. Till the time the importer opts to remove the goods from the warehouse, the importer is required to incur the rent and interest expenditure on the amount of customs duty payable. Since the payment of the custom duty is not due in the current case, the question of regularity does not arise in respect of custom duty. However, it may be noted that the interest and rent that are required to be incurred under section 61 of the Customs Act, 1962 would come under other statutory dues and the auditor would have to examine and comment upon the regularity of the company in depositing such interest and rent.

(f) Non-payment of advance income tax would constitute default in payment of statutory dues. It may, however, happen that the company might not have any taxable income on the due dates on which advance tax is required to be paid. If such a company has an income after the last date on which the advance tax was required to be paid and consequently the company incurs interest under the relevant provisions of the Income Tax Act, 1961, it should not be construed that the company is not regular in depositing advance tax.

(g) It may be noted that at present, no Rules relating to the amount of cess for rehabilitation or revival or protection of assets of sick industrial companies, payable by a company under section 441A of the Act have been notified by the Central Government. Thus, it would not be possible for the auditor to comment on the regularity or otherwise about the cess till the time relevant rules or regulations are issued. However, till the time such Rules are prescribed, the auditor should also state in his report under this clause that the Government has not notified any Rules under section 441A of the Companies Act, 1956 and therefore the auditor is unable to comment on this particular issue.

(h) It may be noted that the auditor has to report on the regularity of deposit of statutory dues irrespective of the fact whether or not there are any arrears on the balance sheet date. This is because there may be situations where a company has deposited the relevant dues before the end of the year while it has been in default in the matter for a significant part of the year. In cases where there are no arrears on the balance sheet date but the company has been irregular during the year in depositing the statutory dues, the auditor should state this fact in his audit report.

(i) For the purpose of this clause, the auditor should consider a matter as "disputed" where there is a positive evidence or action on the part of the company to show that it has not accepted the demand for payment of tax or duty, e.g., where it has gone into appeal. For this purpose, where an application for rectification of mistake (e.g., under section 154 of the Income Tax Act, 1961) has been made by the company, the amount should be regarded as disputed. Where the demand notice/intimation for the payment of a statutory due is for a certain amount and the dispute relates only to a part and not the whole of such amount, only such amount should be treated as disputed and the balance amount should be regarded as undisputed. It is not necessary for the auditor to examine the sustainability or otherwise of the claim of the company regarding disputed amounts. It is sufficient for his purpose if the evidence available shows that the amount is disputed by the company. It may also be noted that the Order has clarified that mere representation to the concerned Department does not constitute the dispute.

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

(k) It may be noted that penalty and/or interest levied under the respective laws would be covered within the term "amounts payable".

(l) The report should be restricted to the actual arrears and should not include the amounts which have not fallen due for payment to appropriate authority and have been recognised as outstanding dues at the balance sheet date.

(m) It is possible that in a large company where there are a number of departments with separate payrolls and where payments are spread over a number of days, the collection of data regarding the provident fund/employees' state insurance collections and the company's contribution thereto may take some time. In order to ensure that deposit of the dues is made in time, the company may make lump-sum deposits of estimated amounts and adjust the excess or deficit against the following month's deposit. If this method is consistently followed and the difference between the total dues and the lump-sum deposit is not significant, it need not be considered that dues have not been regularly deposited and no adverse comment is necessary.

(n) The auditor should make plans to test whether the company is regular in depositing undisputed statutory dues. The auditor, in order to be able to comment on this clause, should have a general understanding of the various statutes governing the company and the dues payable by the company under those statutes. The auditor should also enquire of the management of the company about the statutes under which the company is required to pay any statutory dues. The auditor should also discuss with the management, the policies or procedures adopted for identification and payment of statutory dues. The auditor may also obtain from the management or himself prepare a calendar of dates for submission of various statutory dues by the company for his reference.

(o) The information necessary to comply with this requirement of the Order may be obtained from the company in the form of a statement. The statement should contain a list of various statutes under which the company is required to make payments regularly to appropriate authorities, the kind of payments under each statute, the due date for making the payment to the appropriate authority, the date on which the payment is made by the company, the arrears not due and the arrears over due for more than six months. The auditor should verify the statement provided by the management with the underlying documents and records. The auditor's general understanding of the various statutes governing the company and the dues payable by the company under those statutes would help the auditor in assessing the completeness of the statement. The auditor should recognise that there could be a situation that a statutory due might have become payable but has not been captured by the accounting and internal control systems established by the enterprise and, therefore, the auditor should perform procedures to mitigate risk arising from such a situation.

(p) The auditor should obtain a written representation with reference to the date of the balance sheet from the management:

(i) specifying the cases and the amounts considered disputed;

(ii) containing a list of the cases and the amounts in respect of the statutory dues which are undisputed and have remained outstanding for a period of more than six months from the date they became payable; and

(iii) containing a statement as to the completeness of the information provided by the management.

(q) While the auditor has to report upon the regularity of the deposit, he is not required to specify in detail each instance where there has been a delay or the extent of the delay. It should be sufficient if he indicates whether generally the deposits have been regular or otherwise.

“undisputed statutory dues including provident fund, investor education and protection fund, or employees’ state insurance, income-tax, sales-tax, wealth tax, service tax, custom duty, excise duty, cess have been regularly deposited by the company with the appropriate authorities in all cases during the year”.

“undisputed statutory dues including provident fund, investor education and protection fund, employees’ state insurance, income-tax, sales-tax, wealth tax, service tax, custom duty, excise duty, cess have generally been regularly deposited with the appropriate authorities though there has been a slight delay in a few cases”.

“undisputed statutory dues including provident fund, investor education and protection fund, employees’ state insurance, income-tax, sales-tax, wealth tax, service tax, custom duty, excise duty, cess have not generally been regularly deposited with the appropriate authorities though the delays in deposit have not been serious”.

“undisputed statutory dues including provident fund, investor education and protection fund, employees’ state insurance, income-tax, sales-tax, wealth tax, service tax, custom duty, excise duty, cess have not been regularly deposited with the appropriate authorities and there have been serious delays in a large number of cases”.

(r) If the auditor is of the opinion that the company is not regular in depositing undisputed statutory dues including provident fund, investor education and protection fund, employees’ state insurance, income-tax, sales-tax, wealth tax, service tax, custom duty, excise duty, cess and any other statutory dues with the appropriate authorities, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, are required to be mentioned by the auditor in his audit report. In indicating the arrears, the period to which the arrears relate should also preferably be given and further, wherever possible, the fact of subsequent clearance or otherwise may also be indicated. The following is the format in which the auditor may report the extent of the arrears of outstanding statutory dues:

(b) in case dues of income tax or sales tax or wealth tax or service tax or duty of customs or duty of excise or value added tax or 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 concerned Department shall not constitute a dispute).

Comments:

(a) This clause requires that in case of disputed statutory dues, the amounts involved should be stated along with the forum where the dispute is pending.

(b) The audit procedures applied by the auditor for commenting on the previous clause, including obtaining a statement from the management in regard to the matters specified in the clause, would help the auditor in determining the dues of sales tax/income tax/custom duty/wealth tax/service tax/excise duty/cess that have not been deposited on account of any dispute, the amounts involved and the forum where dispute is pending. The 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.

(c) It is clarified here that mere representation to the concerned Department does not constitute dispute. According to the Order, it is necessary that there should be an appeal before the relevant appellate authority. It is, however, reiterated that where an application for rectification of mistake (e.g., under Section 154 of the Income tax Act, 1961) has been made by the company, the amount should be regarded as disputed.

(d) A show-cause or similar notice generally contains the requirements/queries of the assessing officer. Normally, issuance of a show cause notice by the concerned department should not be construed to be a demand payable by the company. However, in some cases, a show cause notice and demand may be combined in one document. Normally, in such cases, the demand would not be construed to have arisen till the time the assessee has disposed off the requirements of the show cause order. Hence, it would be necessary to evaluate each situation individually.

(e) Tax demands that have been set aside are clearly not 'dues'. Similarly, if a demand has been referred for reassessment and the effect of such referral is the cancellation of the earlier demand, this too would not constitute an amount due. The wording of the order would be of significance; if the demand is not cancelled, it will remain disputed dues. As far as demands that have been stayed are concerned, these should be regarded as disputed dues. These should be disclosed along with a disclosure of the fact of stay. The fact that a stay has been granted does not mean that the authority granting the stay has held that the amount in question is not a valid demand against the company. The stay normally is a concession that the amount may not be deposited immediately or that it may be deposited in installments. Sometimes a stay is granted if the assessee provides a bank guarantee. It may also be noted that there may be a situation that the appellate authority has decided a case in favour of the company but the Department may prefer to make an appeal to a higher authority. In such a case, there is considered to be no dispute until the time the Department makes an appeal to the relevant appellate authority. Further, in case where the amount under the dispute is pending for an appeal to be filed and the time limit for filing the appeal has lapsed, the disputed amount would become a statutory due and the reporting responsibilities of the auditor as are applicable to any other undisputed statutory due under clause 4(ix)(a) of the Order would become applicable. Further, in case where the amount under dispute has not been paid before filing the appeal and no appeal is filed within the time allowed and the time limit for filing the appeal has expired, the disputed amount would become a statutory due.

(f) It is possible that in respect of same nature of statutory dues, there may be more than one dispute pertaining to different periods for which, appeals might have been filed separately. For example, different years' income tax liabilities might have been disputed at different levels of appellate authorities. Hence, in such cases, the information required by the clause should be given separately in respect of each period. In the case of a large company having a number of manufacturing and marketing divisions, it would be quite normal that many cases relating to sales tax, income tax, excise, customs etc., are disputed and are pending at various stages. It cannot be the intention of the clause that each case is listed separately. It is, therefore, proper to summarise the cases stage-wise under each broad head, e.g., sales tax, income-tax, custom duty, excise duty, wealth tax, cess and give the particulars as indicated in paragraph (g) below.

(g) The information required by the clause may be reported in the following format:

(h) Further, a plain reading of the clause suggests that the amounts to be reported under clause 4(ix)(b) of the Order are those which have not been deposited on account of any dispute, irrespective of the treatment of such disputed amounts in accounts. It is quite possible that an amount is disputed and has not been deposited but on consideration of the likely outcome of the dispute, a provision has been made in the accounts. Such an amount will need to be reported, notwithstanding that it has been provided for. Similarly, even if it had not been provided for, it would have to be reported as long as it is not deposited. It is also possible that an amount is disputed, has been deposited and on consideration of the likely outcome of the dispute, has been shown as a recoverable. Though such an amount is not contemplated for reporting under the clause, since it has been deposited, the fact of such deposit having been made under protest should be brought out by the auditor in his report under the clause. Whether a disputed amount should be provided for in the accounts or not will need to be judged in the context of Accounting Standard (AS) 4, "Contingencies and Events Occurring After the Balance Sheet Date and/or Accounting Standard (AS) 29, "Provisions, Contingent Liabilities and Contingent Assets".

(c) whether the amount required to be transferred to investor education and protection fund in accordance with the relevant provisions of the Companies Act, 1956 (1 of 1956) and rules made thereunder has been transferred to such fund within time.

Comments:

The members may note that the provisions relating to the Investor Education and Protection Fund (IEPF) are contained in section 205C of the Companies Act, 1956 and the IEPF (Awareness and Protection of Investors) Rules, 2001. For the purpose of reporting on this clause, the members would need to examine the date of transfer *vis a vis* the time prescribed in the aforesaid provisions and Rules and report accordingly.

Clause (VIII): 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 immediately preceding financial year?

Comments:

(a) The clause is applicable to all the companies, whether manufacturing, trading or service, that have been in existence for five years or more from the date of registration till the last day of the financial year covered by the auditor's report. The clause requires the auditor to report:

- whether the accumulated losses at the end of the financial year are not less than 50% of its net worth; and
- whether the company has incurred cash losses during the period covered by the report and in the immediately preceding financial year covered by the report.

(b) The auditor should compute the accumulated losses and the net worth to verify whether the accumulated losses at the end of the financial year are more than 50% of the company's net worth.

(c) A question arises about the exact connotation of the term "loss" for ascertaining the amount of accumulated losses. More specifically, the issue is whether, for the purpose of reporting by the auditor, the net loss shown by the profit and loss account should be taken as the loss or whether any adjustments need to be made in the figure of such net profit/loss. The term "loss" should be construed to mean the net profit/loss shown by the profit and loss account of the company as adjusted after taking into account qualifications in the audit report to the extent the qualifications are quantified.

(d) Section 2(29A) of the Act defines the term "net worth" as "sum total of the paid-up capital and free reserves after deducting the provisions or expenses as may be prescribed". The explanation to the definition further provides that for the purpose of this definition, "free reserves" means all reserves created out of profits and share premium account but does not include reserves created out of revaluation of assets, write back of depreciation provisions and amalgamation. The provisions or expenses to be deducted from the paid-up capital and reserves for calculating net-worth have not yet been prescribed. It, therefore, implies that the 'net worth' is the sum total of the paid-up capital and free reserves until the provisions or expenses to be deducted therefrom are prescribed under section 2(29A) of the Act. The figure of net worth computed from the balance sheet of the company should also be adjusted for the effect of qualifications in the audit report to the extent the qualifications are quantified.

(e) The auditor is also required to report whether the company has incurred cash losses during the period covered by the report and in the financial year immediately preceding the period covered by the report. In order to determine the figure of cash loss for the financial year, the figure of profit/loss shown by the profit and loss account is adjusted for the effects of transactions of a non-cash nature such as depreciation, amortisation, deferred tax expenses, etc.

(f) The figure of cash loss of the company for the financial year covered by the audit report and the immediately preceding financial year should also be adjusted for the effect of qualifications in the respective audit reports to the extent the qualifications are quantified.

(g) The auditor while reporting on this clause should indicate that his opinion on the matters specified in the clause has been arrived at after considering the effect of the qualifications on the figures of accumulated losses, net worth and cash losses. Where any of the qualifications in the audit report is not capable of being quantified, the auditor should state that the effect of such unquantified qualification(s) has not been taken into consideration for the purpose of making comments in respect of this clause.

(h) Further, a situation may be there where the company has suffered cash losses in only one of the years referred to in the clause. In such a situation, the auditor is well advised to comment on the two years separately. Thus, for example, it would be proper to report that the company has incurred cash losses only during the preceding year but has not incurred any cash loss during the current financial year.

Clause (IX): 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;

Comments:

(a) Under this clause, the auditor is required to report whether the company has defaulted in repayment of dues to a financial institution or bank or to debenture holders. If the answer is in the affirmative, the auditor is also required to mention the period of default and the amount of default. A question that arises is whether the scope of the auditor's inquiry would cover defaults made by the company during the year only or whether the defaults committed in previous years and continuing until the year end would also be covered. It is clarified that the auditor should report the period and amount of all defaults existing at the balance sheet date irrespective of when those defaults have occurred.

(b) Dues to financial institutions¹¹, banks or debenture holders would include the principal as well as any interest on any kind of dues payable to the financial institutions, banks or debenture holders.

(c) The auditor should obtain a schedule of repayments to banks, financial institutions and debenture holders from the management of the company. The schedule should indicate the amount and the due dates of the payments that the company is required to make to banks, financial institutions and debenture holders.

(d) The auditor should examine the agreement or other documents containing the terms and conditions of the loans and borrowings of the company from banks and financial institutions. The auditor should also examine the debenture trust deed. This examination would enable the auditor in verifying the amount and due dates of the payments mentioned in schedule of repayments provided by the management of the company. The auditor should then verify whether the repayments as per the books of account are in accordance with the terms and conditions of the relevant agreement. The auditor should also satisfy himself that the repayment have actually been made to the party concerned.

(e) Though the word "default" has not been defined, in this regard, the word "default" would mean non-payment of dues to banks, financial institutions or debenture holders on the last dates specified in loan documents or debentures trust deed, as the case may be. For example, in the case of term loans, fixed dates are prescribed for repayment in the agreement or terms and conditions of the loans. The dates prescribed for repayments would operate as the last date of payments and any delay after this fixed date would amount to default.

(f) It may happen that the company might have submitted application for reschedulement/restructuring proposals to the lenders, which may be in different stages of processing. Submission of application for reschedulement/restructuring does not mean that no default has occurred. Accordingly, in such situations also the auditor should report the period of default and the amount of default. However, if the application for reschedulement of loan has been approved by the concerned bank or financial institution or if the default has been made good by the company during the accounting period covered by the auditor's report, the auditor should state in his audit report the fact of reschedulement of loan or the fact of default having been made good.

(g) The auditor may come across a situation where there may be disputes between the company and the lender on certain issues relating to repayments. In all such situations, the auditor should give a disclaimer that since

there is a dispute between the company and the lender; he is unable to determine whether there is a default in repayment of dues to the lender concerned.

(h) The following is an example of negative reporting under the clause:

"The company has defaulted in repayment of dues to debenture holders. Debentures amounting to Rs.50,00,000/- became due for redemption on 30th May 20X3 which were redeemed by the company on 15th March 20X4."

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

Comments:

(a) The clause requires the auditor to determine whether the company has given any guarantee for loans taken by others from bank or financial institutions and if yes, whether the terms and conditions of the guarantee are prejudicial to the interest of the company. The scope of the auditor's inquiry under the clause does not extend to the guarantees given by the auditee company for loans taken by "others" from sources "other than bank or financial institutions".

(b) It may be noted that several types of guarantees are in vogue. The type of guarantee within the scope of the clause is the one which the company has provided to a bank or financial institution in respect of loans taken by a third party. In other words, the company has a legal binding to indemnify the bank or financial institution if the third party, on behalf of whom the guarantee has been furnished, fails to fulfill the conditions subject to which the loan was granted by the bank or financial institution. Section 126 of the Indian Contract Act, 1872 defines a contract of guarantee as a contract to perform the promise, or discharge the liability, of a third person in case of his default.

(c) Guarantee given by a company is a contingent liability. In respect of contingent liabilities, the auditor is normally concerned with seeking reasonable assurance that all contingent liabilities are identified and properly valued and disclosed as an off-balance sheet item. The auditor should obtain a written representation from the management that:

- (i) there are no guarantees issued up to the year-end which are yet to be recorded; and
- (ii) all obligations in respect of guarantees have been duly recorded in the register of guarantees and disclosed.

(d) The auditor should examine the Memorandum of Association of the company with a view to determine whether the company can give a guarantee. It may be noted that if a company provides any guarantee without having a clause in this regard in the Memorandum of Association, the act of providing guarantee would be ultra vires. The auditor, in such a situation, should make necessary disclosure in the audit report.

(e) The auditor should also examine the register of guarantees, if any, maintained by the company. The auditor should also obtain a list of the guarantees issued by the company during the year from the management of the company which should be checked with the register of guarantees. The auditor should perform appropriate procedures and examine records like the minutes book of the board meetings, and general meetings to determine that all the guarantees given by the company have been included in the list. The auditor should also ascertain whether the guarantees have been issued by or under sanction of the competent authority.

(f) The auditor should review the issuance of guarantee(s) to establish the reasonableness thereof in the light of previous experience and knowledge of the current year's activities. In determining whether the guarantee is prejudicial to the interest of the company, the auditor would have to give due consideration to a number of factors connected with the guarantee, including the financial standing of the party on whose behalf the company has given the guarantee, party's ability to borrow, the nature of the security offered by the party, the availability of alternative sources of finance and the urgency of the borrowing, if available, for which the company has given guarantee and so on. The auditor should obtain this information from the management.

(g) The auditor should also verify whether the company has complied with the requirements of sections 295 and 372A of the Act. If the company has obtained the previous approval of the Central Government under section 295, it should be construed that the guarantee is not prejudicial to the interest of the company.

(h) If the auditor is unable to comment on the clause because of the absence of the necessary board resolution or the register or other relevant records, the auditor should issue a disclaimer with regard to the clause and should also state the reasons for such a disclaimer.

Clause (XI): Whether term loans were applied for the purpose for which the loans were obtained?

Comments:

(a) This clause requires the auditor to examine whether term loans were applied for the purpose for which these loans were obtained. First of all, the auditor should ascertain whether the company has taken any "term loans". Term loans normally have a fixed or predetermined maturity period or a repayment schedule. In the banking industry, for example, loans with repayment period beyond 36 months are usually known as "term loans". Cash credit, overdraft and call money accounts/deposits are, therefore, not covered by the expression "term loans". Terms loans are generally provided by banks and financial institutions for acquisition of capital assets which then become the security for the loan, i.e., end use of funds is normally fixed.

(b) The Order is silent as to whether this clause also covers term loans obtained from entities/persons other than banks/financial institutions. A strict interpretation of the clause would mean that the term loan obtained from entities/persons other than banks/financial institutions would also have to be examined by the auditor for the purpose of reporting under the clause.

(c) The auditor should examine the terms and conditions subject to which the company has obtained the term loans. The auditor may also examine the proposal for grant of loan made to the bank. As mentioned above, normally, the end use of the funds raised by term loans is mentioned in the sanction letter or documents containing the terms and conditions of the loan. The auditor should ascertain the purpose for which term loans were sanctioned. The auditor should also compare the purpose for which term loans were sanctioned with the actual utilisation of the loans. The auditor should obtain sufficient appropriate audit evidence regarding the utilisation of the amounts raised. If the auditor finds that the funds have not been utilized for the purpose for which they were obtained, the auditor's report should state the fact.

(d) It is not necessary to establish a one-to-one relationship with the amount of term loan and its utilisation. It is quite often found that the amount of term loan disbursed by the bank is deposited in the common account of the company from which subsequently the utilisation is made. In such cases, it should not be construed that the amount has not been utilised for the purpose it was raised.

(e) It may happen that the company might have acquired improved version/model of assets as against the assets for which the loan had been sanctioned. For example, if out of a loan sanctioned for purchase of machinery to be used for manufacture of shoe upper is instead used to purchase a machine, which apart from manufacturing shoe uppers has certain additional manufacturing facilities. In such cases, it should not be construed that the loan has not been applied for the purpose for which it was raised.

(f) Normally, the term lenders directly make the payment to the vendors/suppliers. In such cases, it becomes easier for the auditor to comment on the application of term loans.

(g) During construction phase, companies, generally, temporarily invest the surplus funds to reduce the cost of capital or for other business reasons. However, subsequently the same are utilised for the stated objectives. In such cases, the auditor should mention the fact that pending utilisation of the term loan for the stated purpose, the funds were temporarily used for the purpose other than for which the loan was sanctioned but were ultimately utilised for the stated end-use.

(h) It may so happen that the term loans taken during the year might not have been applied for the stated purpose during the year, for example, the loan was disbursed at the far end of the year. In such a case, the auditor should mention in his audit report that the term loan obtained during the year has not been utilised. This also implies that the auditor, while making inquiry in respect of this clause, should also consider the term loans which although were taken in the previous accounting period but have been actually utilised during the current accounting period.

(i) In case of term loans from banks, raised against title deeds, long term FDRs, NSCs etc., where the bank is not concerned with the purpose for which it is being obtained, the auditor should clearly mention the fact that in absence of any stipulation regarding the utilization of loans from the lender, he is unable to comment as to whether the term loans have been applied for the purposes for which they were obtained. It may, however, be noted that the money for purposes that are prohibited under the law.

(j) Where the auditor concludes that the term loans were not applied for the purpose for which the loans were obtained, the auditor mentions in his report that the amount of term loan as well as the fact that the term loan was not utilised for the purpose for which it was obtained.

Clause (XII): 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.

Comments:

(a) This clause requires the auditor to report whether any fraud has been noticed or reported either on the company or by the company during the year. If yes, the auditor is required to state the amount involved and the nature of fraud. The clause does not require the auditor to discover the frauds on the company and by the company. The scope of auditor's inquiry under this clause is restricted to frauds 'noticed or reported' during the year. The use of the words "noticed or reported" indicates that the management of the company should have the knowledge about the frauds on the company or by the company that have occurred during the period covered by the auditor's report. It may be noted that this clause of the Order, by requiring the auditor to report whether any fraud on or by the company has been noticed or reported, does not relieve the auditor from his responsibility to consider fraud and error in an audit of financial statements. In other words, irrespective of the auditor's comments under this clause, the auditor is also required to comply with the requirements of Standard on Auditing (SA) 240, "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements".

(b) The term "fraud" refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage. Although fraud is a broad legal concept, the auditor is concerned with fraudulent acts that cause a material misstatement in the financial statements. Misstatement of the financial statements may not be the objective of some frauds. Auditors do not make legal determinations of whether fraud has actually occurred. Fraud involving one or more members of management or those charged with governance is referred to as "management fraud"; fraud involving only employees of the entity is referred to as "employee fraud". In either case, there may be collusion with third parties outside the entity. In fact, generally speaking, the "management fraud" can be construed as "fraud by the company" while fraud committed by the employees or third parties may be termed as "fraud on the company".

(c) Two types of intentional misstatements are relevant to the auditor's consideration of fraud— misstatements resulting from fraudulent financial reporting and misstatements resulting from misappropriation of assets.

(d) Fraudulent financial reporting involves intentional misstatements or omissions of amounts or disclosures in financial statements to deceive financial statement users. Fraudulent financial reporting may involve:

- Deception such as manipulation, falsification, or alteration of accounting records or supporting documents from which the financial statements are prepared.
- Misrepresentation in, or intentional omission from, the financial statements of events, transactions or other significant information.
- Intentional misapplication of accounting principles relating to measurement, recognition, classification, presentation, or disclosure.

(e) Misappropriation of assets involves the theft of an entity's assets. Misappropriation of assets can be accomplished in a variety of ways (including embezzling receipts, stealing physical or intangible assets, or causing an entity to pay for goods and services not received); it is often accompanied by false or misleading records or documents in order to conceal the fact that the assets are missing.

(f) Fraudulent financial reporting may be committed by the company because management is under pressure, from sources outside or inside the entity, to achieve an expected (and perhaps unrealistic) earnings target particularly when the consequences to management of failing to meet financial goals can be significant. The auditor must appreciate that a perceived opportunity for fraudulent financial reporting or misappropriation of assets may exist when an individual believes internal control could be circumvented, for example, because the individual is in a position of trust or has knowledge of specific weaknesses in the internal control system.

(g) While planning the audit, the auditor should discuss with other members of the audit team, the susceptibility of the company to material misstatements in the financial statements resulting from fraud. While planning, the auditor should also make inquiries of management to determine whether management is aware of any known fraud or suspected fraud that the company is investigating.

(h) The auditor should examine the reports of the internal auditor with a view to ascertain whether any fraud has been reported or noticed by the management. The auditor should examine the minutes of the audit committee, if available, to ascertain whether any instance of fraud pertaining to the company has been reported and actions taken thereon. The auditor should enquire of the management about any frauds on or by the company that it has noticed or that have been reported to it. The auditor should also discuss the matter with other employees of the company. The auditor should also examine the minute book of the board meeting of the company in this regard.

(i) The auditor should obtain written representations from management that:

(i) it acknowledges its responsibility for the implementation and operation of accounting and internal control systems that are designed to prevent and detect fraud and error;

(ii) it believes the effects of those uncorrected misstatements in financial statements, aggregated by the auditor during the audit are immaterial, both individually and in the aggregate, to the financial statements taken as a whole. A summary of such items should be included in or attached to the written representation;

(iii) it has disclosed to the auditor all significant facts relating to any frauds or suspected frauds known to management that may have affected the entity; and

(iv) it has disclosed to the auditor the results of its assessment of the risk that the financial statements may be materially misstated as a result of fraud.

(j) Because management is responsible for adjusting the financial statements to correct material misstatements, it is important that the auditor obtains written representation from management that any uncorrected misstatements resulting from fraud are, in management's opinion, immaterial, both individually and in the aggregate. Such representations are not a substitute for obtaining sufficient appropriate audit evidence. In some circumstances, management may not believe that certain of the uncorrected financial statement misstatements aggregated by the auditor during the audit are misstatements. For that reason, management may want to add to their written representation words such as, "We do not agree that items and constitute misstatements because [description of reasons]."

(k) Where the auditor discovers that any fraud on or by the company has been noticed by or reported to the management, the auditor should, apart from reporting the existence of fraud, also report the nature of fraud and amount involved. The following is an example of reporting under the clause:

"We have been informed that the accountant of the company had misappropriated funds amounting to rupees ten lakhs during the preceding year and the year under audit. Investigations are in progress and the accountant has been dismissed and arrested. The company has withheld his terminal benefits and it is estimated that the amount misappropriated may not exceed the terminal benefits due to the accountant. The company is also adequately covered by fidelity insurance cover.