

HANDBOOK

Volume I.B

OF

AUDITING PRONOUNCEMENTS

COMPENDIUM OF STATEMENTS

(As on August 1, 2012)



The Institute of Chartered Accountants of India

(Set up by an Act of the Parliament)

New Delhi

Handbook of Auditing Pronouncements

Volume I.B

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(As on August 1, 2012)**



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Foreword

Auditing is our core competence area. As auditors, we need to possess adequate knowledge and skills as well as remain aware of the latest developments in the auditing profession worldwide to respond to the changing expectations of various stakeholders like the clients, the regulators, the Government and the society at large.

As the regulator of the auditing profession in India as well as the auditing standards setting body for the auditors in the country, the Institute of Chartered Accountants of India has been proactive in helping the auditors remain abreast with the changes taking place in the auditing profession worldwide. The Engagement and Quality Control Standards developed by the Auditing and Assurance Standards Board of the ICAI and issued under the authority of the Council of the ICAI represent the best practices in the area of auditing and are harmonised with the globally recognised International Standards issued by the International Auditing and Assurance Standards Board (IAASB).

I am happy that the Auditing and Assurance Standards Board has brought out this 2012 edition of the Handbook of Auditing Pronouncements, which is a one stop compendium of the Engagement and Quality Control Standards, Statements on Auditing and Guidance Notes on Auditing issued by the ICAI. The Handbook contains the text of all the Engagement and Quality Control Standards, Statements on Auditing and Guidance Notes on Auditing issued by the ICAI till August 1, 2012.

I am sure that the members will find the Handbook immensely useful.

August 7, 2012
New Delhi

CA. Jaydeep Narendra Shah
President, ICAI

Preface

In the world today where knowledge reigns supreme, knowledge management is as critical as is knowledge absorption. It therefore gives me immense pleasure to place in your hands, the 2012 edition of the Handbook of Auditing Pronouncements. The Handbook is a one stop reference point for the text of the Quality Control and the Engagement Standards, the Statements on Auditing as well as the generic Guidance Notes on Auditing, issued by the Institute of Chartered Accountants of India currently, in force.

Like its earlier edition, the 2012 edition of the Handbook is also in two volumes, divided in three parts. Volume I.A contains the text of the Standards, Volume I.B contains the text of the Statements and Volume II comprises the text of the Guidance Notes. The readers would find that we have incorporated a number of important decisions of the Council relating to the various Standards and Statements, published as Announcements. For example, the announcement relating to the audit documentation retention period, as mentioned in SQC 1 and the Standard on Auditing (SA) 230, Audit Documentation, or the decision relating to the practitioner's duties in relation to publishing of the review report by the management, pursuant to compliance with paragraphs 61 and 62 of the Standard on Review Engagements (SRE) 2410. Similarly, the Council's decision relating to the auditor's reporting responsibilities on deposit of cess by the company under clause 4(ix)(a) of the Companies (Auditor's Report) Order, 2003 has been reflected in the Statement on CARO 2003. The second volume of the Handbook, i.e., the Guidance Notes, has been updated to include the text of the Guidance Note on Certification of XBRL Financial Statements, issued last year.

At this juncture, I would urge my professional colleagues having articles being trained under them to also encourage the latter to familiarize themselves with the contents of the Handbook. This will not only help them perform more meaningful and quality conscious audit and other engagement but will also lay a foundation for an equally or perhaps more knowledge conscious auditing profession of the future.

I take this opportunity to express my sincere thanks to CA. Jaydeep N. Shah, President, ICAI as well as CA. Subodh Kumar Agrawal, Vice President, ICAI whose vision, guidance and support I have been privileged to receive in the activities of the Board.

Many thanks are also due to my Council colleagues at the Board, viz., CA. Shiwaji Bhikaji Zaware, Vice Chairman, CA. Amarjit Chopra, CA. Anuj Goyal, CA. G. Ramaswamy, CA. Jayant P. Gokhale, CA. J. Venkateswarlu, CA. Naveen N.D. Gupta, CA. Nilesh S. Vikamsey, CA. Pankaj Inderchand Jain, CA. Pankaj Tyagee, CA. Rajendra Kumar P., CA. S. Santhanakrishnan, CA. V. Murali, and Central Government nominee, Shri Gautam Guha and also to the co-opted members at the Board, viz., CA. Raj Agrawal, CA. Vinay Balse, CA. Purshotam Gaggar B., CA. Pramod S. Shingte and CA. Partha S De for their dedication and support to the work plan of the Board and bringing them to fruition. I also wish to place on record my thanks to the special invitees to the Board, viz., Prof. Manoj Anand, CA. B. Padmaja, CA. Amit Roy, Shri S. Ravindran, CA. Khurshed Pastakia, CA. Jaideep Bhargava, CA. Gopal Mahadevan, CA. Anil Sharma, CA. N D Gupta, CA. Raj Kumar Aggarwal, CA. Shashi Gupta and CA. Santosh Gupta for their support to the Board.

I am sure that the members and other interested readers would find this Handbook useful. I look forward to the feedback of readers on the publication.

August 3, 2012
Kolkata

CA. Abhijit Bandyopadhyay
Chairman,
Auditing and Assurance Standards Board

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STATEMENT ON REPORTING UNDER SECTION 227 (1A) OF THE COMPANIES ACT, 1956

**Announcement on Withdrawal of the
Statement on Qualifications in Auditor's Report**
*[Except Paragraphs 2.1 to 2.30 Dealing with Report under section
227 (1A) of the Companies Act, 1956]*

1. Attention of the members is invited to the Statement on Qualifications in the Auditor's Report ("the Statement") issued by the Institute in 1981 (revised in 1984 and 2000). The Statement, primarily, contains guidance on the following aspects of an auditor's report:

- i. reporting in terms of the requirements of section 227(1A) of the Companies Act, 1956; and
- ii. issuance of qualified/ adverse/ disclaimer of opinion.

In addition, the Statement also deals with other related aspects such as the manner of presenting the opinion in the audit report, directors' comments on qualifications, separate report to directors, branch audit reports as also some examples of situations giving rise to other than unqualified opinion.

2. Members' attention is also invited to the Auditing and Assurance Standard (AAS) 28, The Auditor's Report on Financial Statements, issued by the Institute in January 2003. The said AAS, among other things, discusses in details, the fundamental principles and considerations involved in issuing various types of opinions – unqualified, qualified, adverse, disclaimer and emphasis of matter. The Standard also contains illustrations regarding each type of opinion, model audit report, etc.

3. The Council of the Institute at its 269th meeting held on July 18 to 20, 2007 considered the status of the Statement on Qualifications In Auditor's Report *vis-a-vis* Auditing and Assurance Standard (AAS) 28. The Council noted that in terms of the announcement of the Council on the authority

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attached to the documents issued by the Council, on the issuance of a Standard, any Statement on the corresponding subject automatically stands withdrawn. This position could not be applied in case of the Statement on Qualifications in Auditor's Report upon issuance of AAS 28 since, as noted in paragraph 1 above, the Statement contains guidance on certain additional aspects such as, reporting under section 227(1A), manner of making qualifications, the directors' comments on qualifications, separate report to directors and branch audit reports.

4. Paragraphs 1.1 to 1.5 of the Statement on Qualifications in Auditor's Report explain the general principles regarding compliance with section 227 of the Companies Act, 1956, which have become obsolete by now. Also, paragraphs 2.31 to 2.32 of the Statement deal with the reporting under Manufacturing and Other Companies (Auditor's Report) Order, 1975, which also has become obsolete now. Further, paragraphs 3.1 to 4.10 of the Statement on Qualifications in Auditor's Report enunciate the principles involved in issuing other than unqualified reports as well as examples of situations that may give rise to other than a unqualified opinion and suggested wordings therefor. The Council is of the view that these aspects have been amply covered in AAS 28 and also that AAS 28 contains sufficient examples of situations giving rise to other than unqualified opinions as well as suggested wordings. Accordingly, the Council has decided to withdraw the Statement on Qualifications in Auditor's Report except paragraphs 2.1 to 2.30, dealing with report under section 227 (1A) of the Companies Act, 1956.

5. The Council further decided to keep the paragraphs 2.1 to 2.30 of the existing Statement and rename the Statement as "Statement on Reporting under section 227 (1A) of the Companies Act, 1956".

Reporting under Section 227 (1A) of the Companies Act, 1956

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Special Matters in Auditor's Report

Report under Section 227(1A) of the Companies Act

2.1 Section 227(1A) requires the auditor to make certain specific enquiries during the course of his audit. This requirement is without prejudice to his general rights, powers and duties regarding access to books, etc., and obtaining information and explanations. He is, however, not required to report on the matters specified in this sub-section, unless he has any special comments to make on any of the items referred to therein. If he is satisfied as a result of the enquiries, he has no further duty to report that he is so satisfied. It should however be noted that the auditor is required to make only enquiries on the matters specified in the sub-section and is not to investigate into the matters referred to therein.

2.2 Clauses (a) to (f) of Section 227(1A) of the Companies Act are discussed in the following paragraphs.

2.3 Clause (a) requires the auditor to inquire:

"Whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members".

2.4 This clause applies to loans and advances made by the company during the financial year under audit, whether they are outstanding on the date of the Balance Sheet or not. The inquiry should be made in the light of conditions prevailing when the loan or advance was made.

2.5 Loans and advances have not been defined anywhere in the Act. However, having regard to the requirement of clause (d) of the sub-section, a distinction is obviously intended to be made between "loans and advances" and "deposits". A "deposit" may be defined as the placing of money or money's worth with a third party, either for safe keeping, or by way of security for the performance of the depositor's obligations, or for the purpose of earning interest; in the last case deposit being with a party who customarily accepts deposits. Any items required to be disclosed under the head "Loans and Advances" in Part I of Schedule VI to the Act which do not fall within the above definition of a "deposit" should be construed for the purpose of this clause as "loans and advances".

2.6 The clause applies to all loans and advances made "on the basis of security". "Security" for this purpose would include any movable or immovable property, whether belonging to the borrower or not, of which either physical possession or over which a legally effective charge is given to lender.

Reporting under Section 227 (1A) of the Companies Act, 1956

2.7 In order to ascertain that loans and advances are “properly secured”, the auditor should make inquiries to ascertain that *prima facie*:

- (a) the company holds a legally enforceable security, and
- (b) the value of the security fully covers the amount of the loan or advance and is reasonably ascertained.

2.8 In order to comply with requirements of paragraph 2.7(a) above, it will be necessary for the auditor to make appropriate inquiries depending upon the type of security. A few instances are given below:

<i>Type of Security</i>	<i>Documents etc. to be seen</i>
(a) Shares and debentures	The scrips duly transferred in the name of the company.
(b) Government securities, and other securities, documents of title which are transferable by endorsement and delivery, e.g. Bills of Lading, and Railway Receipts.	The scrips or other documents duly endorsed in favour of the lender.
(c) Legal mortgage of immovable properties.	Duly registered mortgage deed.
(d) Equitable mortgage of immovable properties.	Title deeds deposited. In both the above cases, reports on title by lawyers, showing whether the title is free from encumbrances and whether it is marketable, should be called for.
(e) Life Insurance Policy	Assignment of policy in favour of the lender, duly registered with the insurer.
(f) Pledge of goods	Appropriate record of goods held at the balance sheet date.
(g) Hypothecation of goods	Deed of Hypothecation or other document creating the charge, together with a statement of stocks held at the balance sheet date.

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2.9 The valuation of securities which are quoted on a stock exchange would not normally present any problems. For securities which are not so quoted, the auditor should call for the last accounts of the company whose shares or debentures are deposited as security and satisfy himself that *prima facie* the valuation placed on the security by the management is reasonable. In the case of immovable properties, the auditor should satisfy himself that the valuation placed on the property is *prima facie* reasonable. In the case of life insurance policies, the auditor should call for evidence of the surrender value of the policy. In the case of stocks and other goods held on pledge or hypothecation, the Auditor should ascertain that *prima facie* the valuation placed on the goods is in order.

2.10 The loan agreement or correspondence in regard to the terms of the loan or advance should be seen. Where the loan or advance is made to a company, any charge on the assets of such a company should have been registered under Section 125 of the Act in order to constitute an effective security.

2.11 Loans and advances on the basis of security would include loans or advances which are only partly secured from the commencement, or loans or advances which became partly secured subsequently owing to any reason, such as fall in the value of the security. In the case of partly secured loans or advances, it would be advisable to show them separately in the Balance Sheet as "partly secured", indicating the extent to which they are secured.

2.12 The "terms" on which the loan or advance is made would primarily include the security, the interest charged and the terms of repayment. It would be difficult to lay down any general principles regarding the rate of interest which may be charged on loans and advances. Various considerations, such as the position and standing of the borrower, type of security, purpose of the loan, prevailing market rate of interest, etc., would have to be taken into account. If the loan has been given for business considerations, e.g., loans to staff for purchase of cars, houses, etc., loans to suppliers of raw materials or other goods, there may be justification for interest being charged at a rate lower than the market rate, or even, in appropriate circumstances, no interest being charged at all. However, when a loan is given only with a view to earning interest, the interest charged would be at the commercial rate.

2.13 Particular attention should be paid to loans or advances to concerns in which the directors of the company or their associates are interested.

2.14 The question whether the terms on which a loan or advance has been made are "prejudicial to the interests of the company or its members" is a difficult one. Obviously, the auditor is not to inquire as to how such transactions of the company affect the interests of individual members in their personal capacities.

Reporting under Section 227 (1A) of the Companies Act, 1956

The reference to “members” should therefore be construed as a reference to the members of a company as a class, in their capacity as members. The members of the company would be primarily interested in a reasonable return on their investment and in the safety of their capital. The question whether a loan is prejudicial to the interests of the members should therefore be considered from this angle.

2.15 If loan or advance has been approved by the members of the company and/or the Government as required by Section 370 of the Act, this would be a *prima facie* evidence to show that it is not prejudicial to the interests of the company or its members.

2.16. It would appear that, in respect of a continuing loan or advance, the question whether the loan or advance is “properly secured” would have to be considered at the end of each accounting year. However, the question whether a loan is “prejudicial to the interests of the company or its members” would have to be considered only at the time when the loan is given, or renewed.

2.17 Under Clause (b) the auditor has to inquire:

“Whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company.”

2.18. The transactions of a company are ordinarily matters of fact. The purpose of book entries is to correctly record transactions which have, in fact, taken place. If a book entry is passed which is not in accordance with the facts of the transaction, or is contrary thereto, this should be set right or reported upon by the auditor. Again, if book entries are passed purporting to record “transactions” which have, in fact, not taken place, similar considerations would apply. The clause is therefore intended to cover transactions of the company for which the only evidence, or the principal evidence, is the entry regarding the transactions in the books of account. In such cases, the auditor should inquire whether such transactions have in fact taken place and, if so, whether they are prejudicial to the interests of the company.

2.19 Under Clause (c) the auditor has to inquire:

“Where the company is not an investment company within the meaning of section 372 or a banking company, whether so much of the assets of the company as consist of shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company”.

2.20 This clause requires the auditor to inquire in all cases where shares, debentures or other securities have been sold at a price less than their cost. If, as a result of his inquiries, the auditor is satisfied that the sale is *bona fide* and

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the price realised is reasonable, having regard to the circumstances of the cases, he has no further duty to report on the matter.

2.21 The clause applies to companies other than an “investment company” within the meaning of Section 372 or a banking company. The “investment company” referred to in this clause is a company whose principal business is the *acquisition* of shares, stocks, debentures or other securities (vide the proviso to Section 372[10]). It should be noted that clause (c) *applies* to a company whose principal business is dealing in shares, stocks, debentures or other securities.

2.22 Where the investments consist of securities of the same class purchased at various times, and at various prices, the question arises as to the manner of ascertainment of the price at which they were purchased. Such price should be determined in accordance with accepted accounting practice consistently followed by the company.

2.23 Where the cost of shares or debentures or other securities sold is not ascertainable, the book value thereof at the date of sale may be treated as the cost for the purposes of this clause.

2.24 The question of treatment of bonus shares would also arise. When bonus shares are received, the number of shares in the portfolio would be increased by the bonus shares while the cost of the total portfolio would remain the same as before. The result would be that the average cost per unit of the total holding would come down proportionately. The usual accounting practice for apportioning the cost of a part of the total holding on the sale thereof is to take it at its average cost.

2.25 Under Clause (d) the auditor has to inquire:

“Whether loans and advances made by the company have been shown as deposits”.

2.26 A reference is invited to the definition of a “deposit” in contradistinction to that of a loan or advance given in the comments on clause (a) above. It should be noted that the inquiry to be made is whether loans and advances have been shown as deposits, and not *vice versa*.

2.27 Clause (e) requires the auditor to inquire:

“Whether personal expenses have been charged to revenue account”.

2.28 The practice of meeting certain types of personal expenses of employees is normal and is recognised both by the Income-tax Authorities and the Company Law Board. Illustrative of such expenses are the provision of rent-free quarters, conveyance for personal use, medical expenses, expenses on leave travel,

Reporting under Section 227 (1A) of the Companies Act, 1956

maternity benefits, canteen facilities, etc. The charging to revenue of such personal expenses, either on the basis of the company's contractual obligations, or in accordance with accepted business practice, is perfectly normal and legitimate and does not call for any special comment by the auditor. Where, however, personal expenses not covered by contractual obligations or by accepted business practice are incurred by the company and charged to revenue account, it would be the duty of the auditor to report thereon.

2.29 Clause (f) requires the auditor to inquire:

"Where it is stated in the books and papers of the company that any shares have been allotted for cash, whether cash has actually been so received in respect of such allotment, and if no cash has actually been so received, whether the position as stated in the account books and the balance sheet is correct, regular and not misleading."

2.30 It should be noted that the reference is to "books and papers". "Papers" would presumably refer to the Return of Allotment filed by the company under Section 75 of the Act. The law on the subject has hitherto been that, where the consideration for the issue of shares is an adjustment against a *bona fide* debt payable in money on demand by the company, the shares are deemed to have been subscribed in cash (vide the decision in Spargo's Case – 1873, 8, Ch. A. 407). According to the legal opinion obtained by the Institute, the expression "shares allotted for cash" may also include shares allotted against a debt. Therefore, in cases which are covered by the decision in Spargo's case, no comment is required by the auditor, even though the company may have in the Return of Allotment under Section 75, shown such shares as allotted against adjustment of a debt.

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STATEMENT ON THE COMPANIES (AUDITOR'S REPORT) ORDER, 2003*

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* Revised edition, issued in 2005.

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

Introduction

1. The Central Government, in exercise of the powers conferred, under sub-section (4A) of section 227 of the Companies Act, 1956 (hereinafter referred to as "the Act"), issued the Companies (Auditor's Report) Order, 2003, (CARO, 2003) *vide* Notification No. G.S.R. 480(E) dated June 12, 2003. CARO, 2003 contained certain matters on which the auditors of companies (except of those categories of companies which are specifically exempted under CARO, 2003) have to make a statement in their audit report. The text of the CARO, 2003 is given in **Appendix I** to the Statement. The Central Government *vide* Notification No.GSR.766(E) dated November 25, 2004 amended the said Order and issued the Companies (Auditor's Report) (Amendment) Order, 2004 which is reproduced in **Appendix II**. The term, "Order", as used in the following text refers to the CARO, 2003 issued originally in June 2003 as amended by the Amendment Order issued in November 2004. For ease of reference and better understanding of the readers, the contents of the final Order, after incorporating the requirements of the Amendment Order is given in **Appendix III**. A comparative chart of the requirements of the Companies (Auditor's Report) Order, 2003 *vis a vis* Companies (Auditor's Report) (Amendment) Order, 2004 is given in **Appendix IV** to the Statement.

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

3. The purpose of this Statement¹ is to enable the members to comply with the reporting requirements of the Order. It should, however, be noted that the

¹ The 'Statements' are issued with a view to securing compliance by members on matters which in the opinion of the Council are critical for the proper discharge of their functions. 'Statements' therefore are mandatory. Accordingly, while discharging their attest function, it will be the duty of the members of the Institute to ensure that the 'Statements' relating to auditing matters are followed in the audit of financial information covered by their audit reports. If for any reason a member has not been able to perform an audit in accordance with such 'Statements', his report should draw attention to the material departures therefrom. Attention is invited in this regard to the "Clarification regarding Authority Attached to the Documents Issued by the Institute" published in the December, 1985 issue of the Institute's Journal "The Chartered Accountant". The Clarification has also been published in the Handbook of Auditing Pronouncements, May, 2008 Edition, under the title, "Announcements of the Council regarding Status of Various Documents Issued by the Institute of Chartered Accountants of India."

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clarifications and explanations contained in this Statement are not intended to be exhaustive and the auditors should exercise their professional judgment and experience on various matters on which they are required to report under the Order.

General Provisions Regarding Auditor's Report

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

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

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

6. The Order is not intended to limit the duties and responsibilities of auditors but only requires a statement to be included in the audit report in respect of the matters specified therein. For example, examination of the system of internal control is one of the basic audit procedures employed by the auditor. The fact that the Order requires a statement regarding the internal control applicable to purchases of inventories, fixed assets and sale of goods only is no justification

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for the auditor to conclude that an examination of internal control regarding the other areas of a company's business is not important or not required.

Applicability of the Order

Companies Covered by the Order

7. The Order applies to all companies except certain categories of companies specifically exempted from the application of the Order.

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

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

In respect of foreign companies, an established place of business in India would include a liaison office.

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

Companies not Covered by the Order

10. Paragraph 2 of the Order provides that it shall not apply to:

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

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11. The Order specifically exempts banking companies, insurance companies and companies which have been licensed to operate under section 25 of the Act. Section 25 applies to companies which have been formed or are about to be formed as limited companies for promoting commerce, art, science, religion, charity or any other useful object and which apply or intend to apply their profits, if any, or other income in promoting their objects and prohibit the payment of any dividend to their members. Such companies are usually in the form of clubs, chambers of commerce, research institutions, etc. Further, the Order would not also apply in case of non-banking finance company, which converts into a banking company and as on the balance sheet date is a banking company.

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

13. The Order also exempts from its application a private limited company which fulfils all the following conditions throughout the reporting period covered by the audit report:

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

14. A private limited company, in order to be exempt from the applicability of the Order, must satisfy all the conditions mentioned above cumulatively. In other words, even if one of the conditions is not satisfied, a private limited company's auditor has to report on the matters specified in the Order.

(i) Private Limited Company

15. The term "private limited company", as used in the Order, should be construed to mean a company registered as a "private company" {as defined in clause (iii) of sub-section (1) of section 3 of the Act} and which has a limited liability. In other words, the Order would be applicable to private unlimited companies irrespective of the size of their paid-up capital and reserves, turnover, borrowings from banks/financial institutions².

16. Another important issue to consider in respect of reporting under the

² One of the conditions imposed by the Order issued originally in June 2003 for exempting a private limited company was that it should not have accepted any public deposits. The Amendment Order issued in November 2004, however, dropped this requirement in view of the fact that by definition, a private company cannot accept public deposits.

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Order is the reporting responsibilities of the auditor of a branch of a private limited company in case the branch fulfills the conditions for exemption from the applicability of the Order. In this regard, it may be noted that the conditions to be satisfied for being exempt from the applicability of the Order have been laid down in respect of the company taken as a whole. Therefore, a branch of a company does not qualify to be exempted from the applicability of the Order, if the Order is applicable to the company. The branch auditor has the same reporting responsibilities in respect of the branch as those of the auditor appointed under section 224 of the Act has in respect of the company. The comments of the branch auditor in respect of the branch are dealt with by the auditor of the company appointed under section 224 of the Act while finalizing his report under the Order.

(ii) Paid-up Capital and Reserves

17. Sub-section (32) of section 2 of the Act defines the term "paid-up capital" as capital credited as paid-up. The Guidance Note on Terms Used in Financial Statements, issued by the Institute of Chartered Accountants of India, defines the term "paid-up share capital" as, "that part of the subscribed share capital for which consideration in cash or otherwise has been received. This includes bonus shares allotted by the corporate enterprise". Paid-up share capital would include both equity share capital as well as the preference share capital. While calculating the paid-up capital, amount of calls unpaid should be deducted from and the amount originally paid-up on forfeited shares should be added to the figure of paid-up capital. Share application money received should not be considered as part of the paid-up capital.

18. The Guidance Note on Terms Used in Financial Statements defines the term "reserve" as, "The portion of earnings, receipts or other surplus of an enterprise (whether capital or revenue) appropriated by management for a general or specific purpose other than provision for depreciation or diminution in the value of assets or for a known liability. The reserves are primarily of two types: capital reserves and revenue reserves". Clause 7(1)(b) of Part III of Schedule VI to the Act also defines the term "reserve" by way of a negative explanation. According to the said definition, the expression "reserve" does not include any amount written off by way of providing for depreciation, renewals or diminution in the value of assets or retained by way of providing for any known liability. Thus, a reserve has to be clearly distinguished from a provision.

19. As mentioned in the preceding paragraph, reserves are primarily of two types—capital reserves and revenue reserves. According to the Guidance Note on Terms Used in Financial Statements, the term "capital reserve" means "a reserve of a corporate enterprise which is not available for distribution as

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dividend". The said Guidance Note defines the term "revenue reserve" as "any reserve other than capital reserve". For determining the applicability of the Order to a private limited company, both capital as well as revenue reserves should be taken into consideration while computing the limit of rupees fifty lakhs prescribed for paid-up capital and reserves. Revaluation reserve, if any, should also be taken into consideration while determining the figure of reserves for the limited purpose of determining the applicability of the Order. The credit balance in the profit and loss account should also be considered as a part of reserve since the balance in the profit and loss account is available for general purposes like declaration of dividend. The debit balance of the profit and loss account, if any, should be reduced from the figure of revenue reserves only. Therefore, if the company does not have revenue reserves, debit balance of profit and loss account cannot be reduced from the figures of paid-up capital, capital reserves and revaluation reserves. For example, if the company has Rs. 40 lakhs of paid up share capital, Rs. 5 lakhs as Revaluation Reserve, Rs. 6 lakhs in Capital Reserve and Rs. 6 lakhs as debit balance in the Profit and Loss Account, the amount of Rs. 6 lakhs standing to the debit of Profit and Loss Account cannot be deducted from the figures of Rs. 11 lakhs, being the total of the Revaluation Reserve and the Capital Reserve. However, miscellaneous expenditure to the extent not written off should not be deducted from the figure of reserves for the purpose of computing the above limit.

(iii) Loan Outstanding

20. Loans from banks or financial institutions are normally in the form of term loans, demand loans, export credits, working capital limits, cash credits, overdraft facilities, bills purchased or discounted. Outstanding balances of such loans should be considered as loan outstanding for the purpose of computing the limit of rupees twenty five lakhs. Non-fund based credit facilities, to the extent such facilities have devolved and have been converted into fund-based credit facilities, should also be considered as outstanding loan. The figures of outstanding loan would also include the amount of bank guarantees issued by the company where such guarantee(s) has (have) been invoked and encashed or where, say, a Letter of Credit has devolved on the company. In case of term loans, interest accrued and due is considered as a loan whereas interest accrued but not due is not considered as a loan. Further, in case the company enjoys a facility, say, a cash credit facility, whose balance is fluctuating in nature, the Order would apply to the company in case on any day during the financial year concerned, the amount outstanding in the cash credit facility exceeds Rs. 25 lakhs. The condition laid down in the Order is that the outstanding loan from a bank or financial

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institution is exceeding Rs. 25 lakh. There is no stipulation in the Order that the loan should be a long-term loan or a short-term loan or that it should be a secured loan or an unsecured loan. Therefore, the Order would be applicable to a private limited company even if the loan outstanding is a short-term loan. Further, the condition would also apply notwithstanding the fact that the company has been granted an overdraft facility against, say, fixed deposits, of the company with the concerned bank. Moreover, outstanding dues in respect of credit cards would also be considered while calculating the limit of Rs. 25 lakh in respect of loan outstanding from a bank or financial institution. It is clarified that since the words used by the Order are 'any bank or financial institution', the limit of "exceeding twenty five lakh rupees" would apply in aggregate to all loans and not with reference to each bank or financial institution. For example, if a private limited company has three outstanding loans of rupees nine lakhs each from two banks and a financial institution, the Order would be applicable to such a private limited company.

21. Another important point to note with respect to loans outstanding is that even in case where the company had taken a loan from a bank in excess of Rs. 25 lacs but the year end balance of the same is NIL, the company would be covered by the Order notwithstanding that it fulfills all other conditions for exemption from the Order.

(iv) Financial Institution

22. Explanation to sub-clause (xi) of Rule 2(b) of the Companies (Acceptance of Deposits) Rules, 1975 explains the term "financial institution". The term "financial institution" used in the Order should be construed to have the same meaning as assigned to it in the explanation to the said sub-clause in the Companies (Acceptance of Deposits) Rules, 1975. It may, however, be noted that a non-banking financial company is not a "financial institution". A list of financial institutions covered under the Rules is given in **Appendix VI** to this Statement. Further, private banks or foreign banks are banking institutions under the Banking Regulation Act, 1949. Therefore, loans taken from a private bank or a foreign bank would also be taken into consideration while examining the applicability of the Order

(v) Turnover

23. The term, "turnover", has not been defined by the Order. Part II of Schedule VI to the Act, however, defines the term "turnover" as the aggregate amount for which sales are effected by the company. It may be noted that the

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“sales effected” would include sale of goods as well as services rendered by the company. In an agency relationship, turnover is the amount of commission earned by the agent and not the aggregate amount for which sales are effected or services are rendered. The term “turnover” is a commercial term and it should be construed in accordance with the method of accounting regularly employed by the company. For ascertaining the limit of rupees five crores:

- (a) sales tax collected or excise duty collected should not be taken into account if they are credited separately to sales tax account or excise duty account;
- (b) trade discounts should be deducted from the figure of turnover;
- (c) commission allowed to third parties should not be deducted from the figure of turnover;
- (d) sales returns should be deducted from the figure of turnover even if the returns are from the sales made in the earlier years. As a corollary, any sales returns etc., in respect of the sales made during the year under report, if received after the end of that year, would not be deductible from the figure of turnover of such year; and
- (e) The income received by way of rent or dividend/interest would not form part of “turnover”. However, Part II of Schedule VI to the Companies Act, 1956 clarifies that in case of companies rendering or supplying services, gross income derived from services rendered or supplied, would be shown as turnover. Therefore, in cases where the principal business of the company is letting out of property of the company or it is an investment company, the rent or dividend/interest, respectively, would constitute “turnover”.

(vii) Date of Determination of Limits

24. The Order clarifies the point of time at which various limits laid down by the Order are to be tested for determining its applicability to a private limited company. It clarifies that the Order would become applicable to a private limited company if, at any point of time, during the financial year covered by the audit report:

- (a) its paid-up capital and reserves exceed the limit of rupees fifty lakh; or
- (b) it has loan outstanding exceeding rupees twenty five lakh, or
- (c) its turnover exceeds rupees five crore.

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Effective Date of the Order

25. The Companies (Auditor's Report) Order, 2003 (CARO, 2003) was issued in June 2003 and came into force on the 1st day of July 2003. The said Order, from the date it came into force, superceded the MAOCARO, 1988. Further, the Order requires that every report made by the auditor under section 227 of the Act on the accounts of every company examined by him to which the Order applies, for every financial year ending on any day on or after the commencement of this Order, shall contain matters specified in paragraphs 4 and 5 of the said Order. This implies that the auditor's report, on accounts in respect of financial year ending on or before 30th June 2003, even if issued on or after 1st July 2003 is not required to contain report on matters specified in the CARO, 2003. However, the auditor's report, in such cases, should include a statement on matters specified in the erstwhile MAOCARO, 1988.

The Ministry of Company Affairs of the Government of India, subsequent to issuance of the Order, has issued a Circular numbered, GC No. 32/2003 as regards the date of compliance with the Order. According to the Circular, the companies to whom the Order is applicable should make serious efforts to comply with the new CARO, 2003 from the effective date. In the cases of non-compliance for accounts pertaining to financial year which closes on 31st December 2003 or earlier, Government would take a lenient view provided the accounts at least carry MAOCARO Report, if required. The circular, however, provides that accounts in respect of financial years ending on 1st January 2004 or thereafter, will have to strictly follow the CARO, 2003. The Circular is reproduced in **Appendix VII**.

26. The Government's notification notifying the Companies (Auditor's Report) (Amendment) Order, 2004 clarifies that the Amendment Order would be effective from the date of its publication in the Official Gazette; i.e., November 25, 2004. Therefore, all audit reports issued on or after November 25, 2004 are required to comply with amendments contained herein read with the Companies (Auditor's Report) Order, 2003 of June 12, 2003.

27. The requirements of the Order apply in relation to full financial year irrespective of the fact that a part of such year may fall prior to the date of coming into force of the Order. Under some of the requirements of the Order, the auditor has to comment on the records maintained by the company, systems and procedures in vogue. It is possible that during the period prior to 1st July 2003, many of the companies might not have maintained such records or established such systems and procedures as are envisaged in the Order primarily because such requirements were not part of erstwhile MAOCARO, 1988 and were thus, not required to be commented upon by the auditor. It is advisable that in such

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situations, the auditor should also clearly mention the fact of non-maintenance of such records or non-existence of systems and procedures while making comments under the relevant clauses.

Period of Compliance

28. A question might arise as to the period in relation to which the auditor should comment or report upon the matters specified in the Order. For example, several of the questions relate to the maintenance of proper records. What should be the position of the auditor when records were improperly maintained for some part of the financial year but have been properly maintained at the balance sheet date? One view of the matter would be that no adverse report is necessary since the deficiencies existing during the year have been rectified before the auditor makes his report. However, this view does not recognise the fact that maintenance of records is not an end by itself but is a necessary condition for the auditor to satisfy himself regarding the authenticity of the transactions on which he is reporting. The better view, therefore, is to consider that the auditor is reporting on the state of affairs as they existed during the accounting year and compliance with the requirements of the Order should be judged with reference to the whole accounting year and not merely with reference to the position existing at the balance sheet date or the date at which he makes his report. However, in deciding whether or not to make an adverse comment, the auditor should consider what detrimental effect, if any, has been caused by the failure to comply with the requirements of the Order for any part of the year. For example, if records for fixed assets were not properly maintained for some part of the year but were properly maintained at the balance sheet date and physical verification was made after the records were properly maintained, there is no detrimental effect on the company. However, if internal control with respect to the items specified in the relevant clause of the Order was inadequate during a part of the year, some detrimental effect on the company could have occurred.

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

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

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terms whether or not the requirements have been complied with.

General Approach

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

32. The auditor should, in regard to the requirements of the Order, apply the same degree of examination, as he would do in a normal audit. Thus, the degree of examination required should be such as is adequate to enable the auditor to comment on matters specified in the Order. In this context, the auditor should also comply with the requirements of the Standards on Auditing issued by the Institute.

33. It is possible that for the purposes of the Order, the auditor needs greater information from the management and, therefore, closer interaction with the management becomes necessary. This will ensure that there is sufficient advance planning regarding the manner in which the examination necessary for reporting on matters specified in the Order would be carried out by the auditor and the form in which the company should maintain its records so that they provide the necessary information and evidence to the auditor. An example of this would be the documents and records to be maintained by the company to provide the requisite evidence to the auditor regarding verification of fixed assets or inventories. It is, therefore, suggested that the auditor should intimate to the management, in writing, his requirements before the commencement of each audit. The auditor should also consider intimating additional requirements, if any, during the course of the audit. The auditor should also consider obtaining management representations, on matters on which the Order requires the auditor make a statement on certain aspects. An example of this would be the clause requiring the auditor to state whether the funds raised on short-term basis have been used for long-term investment.

34. For a number of reasons, the necessity for preserving working papers by the auditors assumes greater importance in the context of the requirements of the Order. Firstly, there should be evidence that the opinion expressed by the auditor is based on an examination made by him. Secondly, there should be evidence to show that in arriving at his opinion, the auditor has given due cognisance to the information and explanations given by the company and that

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his opinion is not arbitrary. Thirdly, there should be evidence to show that the information and explanations obtained were full and complete, that is, the auditor has called for all the information and explanations which were necessary to be considered before arriving at his opinion. Finally, there should be evidence to show that the auditor did not merely rely upon the information or explanations given by the company but that he subjected such information and explanations to reasonable tests to verify their accuracy and completeness.

35. The auditor should comply with the requirements of Standard on Auditing (SA) 230, "Documentation". The auditor may take the following steps to ensure that he has adequate working papers to support the conclusions drawn in his report:

- (a) submit to the company, a questionnaire on all important matters covered by the Order.
- (b) make specific inquiries in writing on all important matters not covered by the questionnaire.
- (c) insist that replies of the company are furnished in writing and are signed by a responsible officer of the company.
- (d) where the explanations are not already separately recorded, maintain a record of the discussions with the management.
- (e) prepare his own "check-list" in respect of the requirements of the Order and record the names of the members of his staff who made the examination and the name of the company's staff who provided the information. An illustrative check-list in respect of the requirements of the Order is given in **Appendix VIII** to the Statement.

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

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

38. It is also necessary that in deciding upon the reasonableness of a course of action taken by the management, the auditor gives due consideration to the

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facts and circumstances existing when the decision was taken and the information known or available to the management at that time. He should not allow his judgement to be clouded by "hind-sight". He should examine the transaction in the context of normal business operations and not in a theoretical or artificial set of circumstances.

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

40. It may be noted that while reporting on matters specified in the Order, the auditor should consider the materiality of the item involved in determining the nature, timing and extent of audit procedures to be performed. For example, the auditor, in the case of a *nidhi*/mutual benefit fund/societies, while reporting, whether the repayment schedule of various loans granted by the *nidhi* is based on the repayment capacity of the borrower, the auditor examines the loan documentation of all large loans and conducts a test check examination of the rest, having regard to the materiality.

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

42. The Order places a considerable responsibility on the auditor. If he is to discharge his duties under the Order properly, he should obtain, on the one

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hand, the co-operation of the management and on the other, the respect and confidence of the members to whom he is reporting. He can do so if he makes his report honestly and fearlessly and if he brings to bear on his work, the professional qualities of independence, balance of judgement and fair-play which he possesses as a result of his education, training and experience.

Matters to be Included in the Auditor's Report

43. The matters to be included in the auditor's report are specified in paragraph 4 of the Order. Unlike the MAOCARO, 1988, which required different sets of statements for different classes of companies, the present Order requires the auditor of a company to comment upon all the clauses irrespective of the nature of the company's business. However, in respect of *nidhi*/mutual benefit funds/societies, four additional sub-clauses under clause (xiii) are to be commented upon by the auditor. Further, clause (xiv) applies only to companies dealing or trading in shares, securities etc.

44. *Whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets.* [Paragraph 4(i)(a)]

Comments

- (a) The 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;

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- (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 amortised 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 amortisation 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

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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-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 computerised 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 finalised, 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

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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:

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- (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.

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- (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, trade marks and designs are normally identifiable by the purchase agreements or the letters granting patent and by registration references in case of trade marks and designs.
 - (x) Vehicles can be identified by reference to the registration books.
 - (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

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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.

45. *Whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account; [Paragraph 4(i)(b)]*

Comments

- (a) 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

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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.

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- (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.

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

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Comments

- (a) This clause requires the auditor to comment, in case where a substantial part of the fixed assets has been disposed off during the year, whether such disposal has affected the going concern status of the company.
- (b) Accounting Standard (AS) 1, "Disclosure of Accounting Policies" states, "the enterprise is normally viewed as a going concern, that is, as continuing in operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations".
- (c) The auditor, in the normal course, when planning and performing audit procedures and in evaluating the results thereof, is required to consider the appropriateness of the going concern assumption underlying the preparation of financial statements in accordance with the requirements of Standard on Auditing (SA) 570, "Going Concern". As a result of such audit procedures and evaluation, if the auditor is of the opinion that there exists any indication of risk that the going concern assumption might not be appropriate, the auditor should gather sufficient appropriate audit evidence to resolve, to his satisfaction, the question regarding the company's ability to continue operations for the foreseeable future. It may be noted that the sale of substantial part of fixed assets is one of the several such indications of risk. This clause of the Order pre-supposes the existence of such risk and, therefore, requires the auditor to examine whether the company has disposed off substantial part of fixed asset(s) during the period covered by his report and, if yes, whether the disposal of such part of the fixed assets has affected the going concern status of company. It should also be noted that this requirement of the Order does not absolve the auditor from his responsibilities regarding the appropriateness of the going concern assumption as a basis for preparation of financial statements. Since there could be several other indications of such a risk, the auditor, notwithstanding his comments under the clause, should also comply with the requirements of SA 570, "Going Concern" while discharging his attest function.
- (d) Sale of substantial part of fixed assets should be construed to have affected the going concern if the auditor is not able to resolve, to his satisfaction, the question regarding the entity's ability to continue in operation for the foreseeable future keeping in view the sale of substantial part of fixed assets or if the auditor comes to a conclusion that sale of substantial part of fixed assets has rendered the going concern assumption inappropriate.

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- (e) The Order does not define the word “substantial”. The response to the issue as to what constitutes “substantial part of fixed assets” depends primarily upon the facts and circumstances of each case. The auditor should use his professional judgement to determine whether an asset or group of assets sold by the company is a substantial part of fixed assets. In this case, the auditor may note that section 293(1)(a) of the Act deals with the sale, lease or otherwise disposal of the whole or substantially the whole, of the undertaking of the company. It may be noted that such a situation may not necessarily tantamount to sale of substantial part of the fixed assets of the company. However, such an approval of the shareholders might be an indication that the company has sold or has the intention of selling substantial part of its fixed assets. The audit procedures, in such a case, would also include examination of the minutes of the general meeting(s) where the matter was discussed and the resolution passed by the shareholders in this regard.
- (f) The auditor should carry out audit procedures to gather sufficient appropriate audit evidence to satisfy himself that the company shall be able to continue as a going concern for the foreseeable future despite the sale of substantial part of fixed assets. These procedures may include:
 - (i) discussion with the management and analysis as to the significance of the fixed asset to the company as a whole;
 - (ii) scrutiny of the minutes of the meetings of the board of directors and important committees for understanding the entity’s business plans for the future (for example, replacement of the substantial part of the fixed asset disposed off with another fixed asset having more capacity or for taking up a more profitable line of business);
 - (iii) review of events after the balance sheet date for analysing the effect of such disposal of substantial part of fixed asset on the going concern.
- (g) The auditor should also obtain sufficient appropriate audit evidence that the plans of the management are feasible, are likely to be implemented and that the outcome of these plans would improve the situation. The auditor should also seek written representation from the management in this regard.
- (h) Where the company has disposed off substantial part of fixed assets, the auditor should consider whether the disposal of such part of fixed assets has triggered the risk of going concern assumption being no longer appropriate. It is possible that such risk is mitigated by factors such as

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those referred to in (f)(ii) above. If, in the auditor's judgement, the going concern assumption is appropriate because of mitigating factors, in particular because of management's plans for future action, the auditor, apart from reporting that sale of substantial part of fixed assets has not affected the going concern, should also consider whether such plans or other factors need to be disclosed in the financial statements. Where the auditor concludes that such plans or other factors need to be disclosed in the financial statements, but have not been adequately disclosed in the financial statements, the auditor should express a qualified or adverse opinion, as appropriate in accordance with the requirements of Standard on Auditing (SA) 700, "The Auditor's Report on Financial Statements", issued by the Institute of Chartered Accountants of India.

- (i) An auditor might also come across a situation where the assets have not been put to use but are being held for sale or have been abandoned because of non viability of the project or for any other reason and, therefore, excluded from the schedule of fixed assets and accordingly, shown under the head sales/ adjustments. Such abandoned or held for sale fixed assets are shown separately in the financial statements in terms of paragraph 24 of Accounting Standard (AS) 10, Accounting for Fixed Assets. The auditor in such a case, should examine the records maintained in respect of these assets in terms of paragraph 44(c) of the Statement and should consider such assets also while commenting upon this clause of the Order. It should, however, be noted that these assets may form substantial part of fixed assets but their disposal or sale might not affect the going concern.
- (j) Another peculiar situation that might be faced by the auditor in reporting on this clause is where, say, a substantial change in the nature of activities being carried on by the company, requiring it to dispose off its plant and machinery etc. For example, where a manufacturing company has closed down its manufacturing operations, sold off its plant and equipment and has converted itself into a trading company, whether it can still be considered as a going concern. In resolving this issue, guidance can be drawn from Accounting Standard (AS) 1, Disclosure of Accounting Policies, which states that "the enterprise is normally viewed as a going concern, that is as continuing its operation for the foreseeable future. It is assumed that the enterprise has neither the intention nor the necessity of liquidation or of curtailing materially the scale of its operations." Thus, in such a scenario, though the company has disposed off its plant and equipment, it is still a going concern in the form of a trading company. The auditor in such cases would also draw guidance from the principles

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laid down in the Standard on Auditing (SA) 570, "Going Concern", for assessing the appropriateness of the going concern assumption.

- (k) In case the company has sold a substantial part of the fixed assets and the going concern question is not resolved to the satisfaction of the auditor, the auditor should, while commenting on the clause, state that sale of substantial part of fixed assets has affected the going concern status of the company. In so far as the opinion of the auditor on the financial statements is concerned, the auditor should ordinarily express an unqualified opinion if adequate disclosures³ in regard to the going concern problem not having been resolved are made in the financial statements. However, he should, in his report, add a paragraph that highlights the going concern problem by drawing attention to the notes to the financial statements. The following is an example of such a paragraph:

"We draw attention to Note X in the financial statements. The Company has sold a substantial part of its fixed assets during the year covered by our report. The company has so far not made any plans to replace the fixed assets that have been sold. These factors, along with other matters as set forth in Note X, raise substantial doubt about the company's ability to continue as a going concern in the foreseeable future."

- (l) In case the going concern question is not resolved to the satisfaction of the auditor and adequate disclosure is not made in the financial statements, the auditor should express a qualified or adverse opinion, as appropriate. The following is an example of the explanation and opinion paragraphs when a qualified opinion is to be expressed:

"The Company has sold a substantial part of its fixed assets during the year covered by our report. According to the information and explanations given to us, the company has so far not made any plans to replace the substantial part of fixed assets that have been sold. There exists a substantial doubt that without replacement of such substantial part of fixed assets, the company will be able to continue as a going concern for the foreseeable future. Consequently, adjustments may be required to the recorded amounts of assets and classification of liabilities. The financial statements (and notes thereto) do not disclose this fact."

³ Reference may also be made to paragraphs 15 and 16 of Standard on Auditing (SA) 570, "Going Concern."

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In our opinion, subject to the omission of the information dealt within the preceding paragraph, the financial statements give a true and fair view of the financial position of the Company at March 31, 20XX and the results of its operations for the year then ended."

- (m) If, based on the additional procedures carried out and the information obtained, including the effect of mitigating circumstances, the auditor's judgment is that the entity will not be able to continue in operation for the foreseeable future, i.e., going concern assumption considered inappropriate, the auditor should comment that the sale of substantial part of fixed assets has adversely affected the going concern status of the company. Further, the auditor would also conclude in main report that the going concern assumption used in the preparation of the financial statements is inappropriate. If the result of the inappropriate assumption used in the preparation of the financial statements is so material and pervasive as to make the financial statements misleading, the auditor should express an adverse opinion.

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

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

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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.

48. *Are the procedures of physical verification of inventory followed by the management reasonable and adequate in relation to the size of the company and the nature of its business? If not, the inadequacies in such procedures should be reported.* [Paragraph 4(ii)(b)]

Comments

- (a) This clause requires the auditor to comment on the reasonableness and adequacy of the inventory verification procedures followed by the management of the company. In case the procedures of physical verification of inventories, in the opinion of the auditor, are not reasonable and adequate in relation to the size of the company and the nature of its business, 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

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of records of verification inventory is 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

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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;

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- (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.

49. *Whether the company is maintaining proper records of inventory and whether any material discrepancies were noticed on physical verification and if so, whether the same have been properly dealt with in the books of account.*
[Paragraph 4(ii)(c)]

Comments

- (a) 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.

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- (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.

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- (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.

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

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,

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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.

51. *Whether the rate of interest and other terms and conditions of loans given*

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by the company, secured or unsecured, are prima facie prejudicial to the interest of the company; and [Paragraph 4 (iii)(b)]

Comments

- (a) This clause, read with Paragraph 4(iii)(a) of the Order, requires the auditor to examine and comment whether the rate of interest and other terms and conditions of loans given by the company (whether secured or unsecured) to companies, firms or other parties covered in the register maintained under section 301 of the Act are *prima facie* prejudicial to the interest of the company.
- (b) The auditor should examine agreements entered into by the company with the parties covered in the register maintained under section 301 of the Act or any other supportive documents available for ascertaining the rate of interest and other terms and conditions of all loans granted by the company to such companies, firms or other parties.
- (c) The auditor's duty is to determine whether, in his opinion, the rate of interest and other terms and conditions of the loans given are *prima facie* prejudicial to the interest of the company. The "other terms" would primarily include security, terms and period of repayment and restrictive covenants, if any. In determining whether the terms of the loans are "*prima facie*" prejudicial, the auditor would have to give due consideration to a number of factors connected with the loan, including its ability to lend, borrower's financial standing, the nature of the security, prevailing market rate of interest and so on.
- (d) It may be mentioned that clause (a) of sub-section (1A) of section 227 of the Act also requires the auditor to inquire whether loans and advances made by the company on the basis of security have been properly secured and whether the terms on which they have been made are not prejudicial to the interests of the company or its members. The auditor's inquiry under the aforesaid clause may also be useful for the purposes of reporting under this clause.
- (e) Further, the auditor may also come across a situation where the company has a policy of providing loans at concessional rates of interest to its employees and such a loan has been given to a relative of the director who is also an employee of the company. In such a case also, the auditor would be required to examine and comment whether loan is prejudicial to the interests of the company. It may, however, be noted that normally such rate of interest as per the policy followed by the company cannot be said to be prejudicial to the interest of the company if other employees of

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the company also receive the loan at the same rate of interest.

- (f) The following is an example of reporting under the clause:

“According to the information and explanations given to us, we are of the opinion that the rate of interest and terms and conditions of loans given by the company to a firm in which Mr. X, one of the directors of the company, is interested are *prima facie* prejudicial to the interest of the company on account of following reasons:

- (i) the company has granted the loan at an interest rate of X% per annum which is significantly lower than the interest rate prevailing in the market; and
- (ii) coupled with the (i) above, there are no covenants with regard to the repayment of the loan.”

52. *Whether receipt of the principal amount and interest are also regular; and*
[Paragraph 4 (iii)(c)]

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:

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- (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.

53. *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.*
[Paragraph 4(iii)(d)]

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

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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.

54. *Has the company taken any loans, secured or unsecured from companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and the amount involved in the transactions; and [Paragraph 4(iii)(e)]*

Comments

- (a) The auditor is required to comment on this clause also with reference to the companies, firms or other parties covered in the register maintained under section 301 of the Act.⁴
- (b) The duty of the auditor, under this clause, is to determine whether the company has taken any loans, secured or unsecured from companies, firm or other parties covered in the register maintained under section 301 of the Act.
- (c) 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.

⁴ Attention of the members is also invited to the guidance given in the Statement on Qualifications in Auditor's Report, in respect of "loans shown as deposits" and *vice versa*.

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- (d) Steps to be taken by the auditor are exactly similar as in case of reporting under loans given by the company, as discussed in paragraph 50, such as obtaining list of parties, making separate disclosures, etc., except for the fact that in this case the auditor shall report in respect of loans taken from instead of loans granted to specified parties.

55. *Whether the rate of interest and other terms and conditions of loans taken by the company, secured or unsecured; are prima facie prejudicial to the interest of the company; and [Paragraph 4(iii)(f)]*

Comments

- (a) This clause, read with paragraph 4(iii)(e) of the Order, requires the auditor to examine and comment whether the rate of interest and other terms and conditions of loans taken by the company (whether secured or unsecured) from companies, firms or other parties covered in the register maintained under section 301 of the Act are *prima facie* prejudicial to the interest of the company.
- (b) The auditor should examine agreements entered into by the company with the parties covered in the register maintained under section 301 of the Act or any other supportive documents available for ascertaining the rate of interest and other terms and conditions of all loans taken by the company from companies, firms or other parties covered in the register maintained under section 301 of the Act.
- (c) The auditor's duty is to determine whether, in his opinion, the rate of interest and other terms and conditions of the loans taken are *prima facie* prejudicial to the interest of the company. The "other terms" would primarily include security, terms and period of repayment and restrictive covenants, if any. In determining whether the terms of the loans are "*prima facie*" prejudicial, the auditor would have to give due consideration to a number of factors connected with the loan, including the company's financial standing, financial position, availability of alternative sources of finance, urgency of borrowing, ability to borrow, the nature of the security given, prevailing market rate of interest and so on.

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

Comments

- (a) This sub clause requires the auditor to report upon the regularity of payment of principal amount of loans taken and interest thereon. Again, read with paragraph 4(iii)(e) of the Order, the scope of auditor's inquiry

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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.

- (b) The auditor has to examine whether the payment of principal and interest is regular. The word 'regular' should be taken to mean that the principal and interest should normally be paid whenever they fall due. If a due date for payment of interest is not specified, it would be reasonable to assume that it falls due annually.
- (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)(g) 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 repayment and payment 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 repayment of principal and payment of interest needs to be verified with reference to the books of account of the company to come to the conclusion whether the repayments of principal and payment of interest are regular; and
 - (iv) if the results of the procedures mentioned above indicate any irregularity in payment of principal and/or interest, the auditor should mention the fact in his report.
- (d) Where no stipulation has been made for the repayment of the loan, the auditor is not in a position to make any specific comments. However, the auditor should, in such situations, bring out the fact of non stipulation of any terms of repayment, in his audit report. In case of loans repayable at demand repayment of the loan becomes due as and when the lender calls back the loan.

57. *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.*
[Paragraph 4(iv)]

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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

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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 non-observance 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

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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.

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- (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) are 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.

58. *Whether the particulars of contracts or arrangements referred to in section 301 of the Act have been entered in the register required to be maintained under that section; and [Paragraph 4(v)(a)]*

Comments

- (a) This part of the clause requires that the auditor should report whether the transactions that need to be entered into a register in pursuance of particulars of contracts or arrangements referred to in section 301 of the Act have been so entered. Section 301 of the Act requires that every company shall keep one or more registers in which shall be entered separately, particulars of all contracts or arrangements to which sections 297 and 299 of the Act apply. The following are salient features of sections 301, 297 and 299 of the Act:
 - (i) 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

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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.

- (ii) Under section 297 of the Act, except with the consent of the Board of Directors of a company, a director of the company or his relative, a firm in which, a director or his relative is a partner or any other partner in such a firm, or a private company of which the director is a member or director, shall not enter into any contract with the company—
 - (a) for the sale, purchase or supply of any goods, materials or services; or
 - (b) after the commencement of this Act, for underwriting the subscription of any shares in or debentures of, the company.

It may also be noted that in the case of a company having a paid-up capital of not less than rupees one crore, no such contract can be entered into without the previous approval of the Central Government. Whenever a contract, to which section 297 applies, is entered into, the board of directors accords its approval by a resolution passed at a meeting of the Board, before the date the contract is entered into or within three months of the date on which the contract was entered into. The particulars of such contracts or arrangements including names of the parties to the contract or arrangement are required to be entered into the register maintained under section 301 of the Act.

- (iii) Under section 299 of the Act, every director of a company, who is in any way, whether directly or indirectly, concerned or interested in a contract or arrangement, or proposed contract or arrangement, entered into or to be entered into, by or on behalf of the company, is required to disclose the nature of his concern or interest at a meeting of the Board of Directors. The disclosure required under section 299 of the Act can be made by a director either at a meeting of the Board under sub-section (2) or by way of giving a general notice for disclosure of interest to the Board of Directors under sub-section (3) of section 299 of the Act. The disclosure of interest is made in Form 24AA of Companies (Central Government's) General Rules & Forms, 1956. Based on the disclosures made by directors in Form 24AA, particulars of

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contracts and arrangements including, among other things, the names of the parties concerned are entered into the register maintained under section 301 of the Act.

- (b) It is suggested that the auditor should acquaint himself with all the requirements of sections 297, 299 and 301 of the Act⁵.
- (c) It should also be noted that according to section 299(6), section 301 is not applicable to situations where two companies having common directors enter into a transaction but none of the director, individually or together with the other directors, holds more than two percent of the paid up share capital of the company. Thus, the reporting under this clause pertains only to the loan transactions with the parties covered by section 301 of the Act and does not extend to such situations where loan transactions are entered into with another company where the directors are common but such directors do not hold more than two percent of the paid up share capital.
- (d) It may, however, be noted that as per section 299(6) of the Act, the requirements of section 301 of the Act do not apply to a contract or arrangement entered into or to be entered into between two companies where any of the directors of one of the company or two or more of them together holds or hold not more than two percent of the paid-up share capital in the other company. For example, the mere fact that a director is a shareholder in a public limited company will not mean that he is interested unless, of course he, together with other directors, holds more than 2% or more of the share capital.
- (e) Normally, particulars are entered in the register maintained under section 301 of the Act based on notices received (Form 24AA) from the directors of the company under section 299 of the Act. As mentioned earlier, the directors are required to make a disclosure of interest either at a meeting of the Board of Directors or by way of a general notice under sub-section (3) of section 299 of the Act. Entries are also made in the register on the basis of the approval of the board of directors accorded in terms of section 297 of the Act. In case the company is required to obtain prior approval of the Central Government but has not so obtained, the auditor should state the fact in his report under the Order. A separate qualification may not be required in the main audit report provided the necessary provisions to meet the cost of non-compliance has been made and the fact of non-compliance (including the amounts involved) has been

⁵ Text of sections 297, 299 and 301 of the Act is reproduced in **Appendix X** to the Statement.

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appropriately disclosed in the financial statements.

- (f) The auditor should obtain a list of companies, firms or other parties, the particulars of which are required to be entered in the register maintained under section 301 of the Act. The auditor should verify the entries made in the register maintained under section 301 of the Act from the declarations made by the directors in Form 24AA i.e., general notice received from a director under sub-section (3) of section 299 and on the basis of the approval of the board of directors under section 297 of the Act which would be evident from the minutes of the meetings of the board of directors. The auditor should also obtain a written representation from the management concerning the completeness of the information so provided to the auditor. While the auditor can verify the completeness of the entries in the register maintained under section 301 from Form 24AA in respect of transactions or contracts covered by section 297, the auditor should perform additional procedures to verify the completeness of the entries in the register to which section 297 of the Act applies. The auditor should review the information provided by the management. The auditor should also perform the following procedures in respect of the completeness of this information:
 - (i) review his working papers for the prior years, if any, for names of known companies, firms or other parties the particulars of which are required to be entered in the register maintained under section 301 of the Act; and
 - (ii) review the entity's procedures for identification of companies, firms or other parties the particulars of which are required to be entered in the register maintained under section 301 of the Act.
- (g) The auditor should verify, on the basis of information provided by the management and on the basis of the results of the procedures performed by him, whether transactions that need to be entered into a register in pursuance of section 301 of the Act have been so entered or not. The auditor also evaluates whether the register under section 301 is updated and maintained properly. The auditor should also examine, wherever applicable, secretarial compliance certificate issued under section 383A of the Act in regard to the completeness of the register maintained under section 301 of the Act. The auditor may also rely upon such a certificate issued by a company secretary provided the auditor complies with the requirements of Standard on Auditing (SA) 620, "Using the Work of an Expert".
- (h) There may be situations where the company has not properly maintained

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the register required to be maintained by it under section 301 or has not updated the said register and the necessary declarations from the directors in Form 24AA are also not available on record. In such situations, the auditor should state the fact of non-maintenance/improper maintenance of the aforesaid register, while reporting under this clause. An example of such a reporting by the auditor could be:

“According to the information and explanation given to us, we are of the opinion that the company has not entered all the transactions required to be entered in the register maintained under section 301 of the Companies Act, 1956. The following are the particulars of two such transactions which needed to be entered into the register but were not so entered:

- (i) purchase of plant and machinery costing Rs.2,00,000 from a firm in which one of the directors, Mr. X, is a partner.
- (ii) sale of administrative block building of the company for Rs.1,00,000 to a relative of Mr. Y, one of the directors of the company.”

59. *Whether transactions made in pursuance of such contracts or arrangements have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time.* [Paragraph 4(v)(b)]

[This information is required only in case of transactions exceeding the value of five lakh rupees in respect of any party and in any one financial year.]

Comments

- (a) This clause requires the auditor to comment upon the reasonableness of the prices of all the transactions which have been entered in pursuance of contracts or arrangements covered in the register(s) maintained under section 301 of the Act if such transactions in respect of any party and in any one financial year exceed the value of rupees five lakhs. The auditor is required to determine the reasonableness of prices having regard to the prevailing market prices at the relevant time. It is clarified here that the scope of the auditor's inquiry under this clause is restricted to such transactions to which sections 297 and 299 of the Act apply and thereby required to be entered in the register maintained under section 301 of the Act.
- (b) The auditor should, while reporting on this clause of the Order, in the first instance, determine whether the aggregate value of all the transactions entered into with any of the companies/firms/parties covered in the

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register maintained under section 301 of the Act exceed the value of rupees five lakhs. If so, the auditor has to examine whether each of the transactions entered into with such a company/firm/party have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time.

- (c) The auditor has to examine whether the prices paid for the transactions examined by him are reasonable, having regard to the prevailing market prices at the relevant time. The auditor is not expected to make a roving market inquiry to determine the market prices prevailing at the time the transactions were entered into. However, he may examine information such as price lists, quotations, and records relating to prices at which similar transactions have been entered into with other parties, etc., at the relevant time. The auditor has to satisfy himself, taking into account all the relevant information as well as any explanations given by the management, whether the prices at which various transactions have been made are reasonable. In determining the reasonableness of the prices, the auditor should take into account all the factors surrounding the transactions such as the delivery period/schedule of implementation, the quality and the quantity of the product/service, the credit terms, the previous record of supplier/buyer/client, etc. For example, a company may decide to buy the goods (not necessarily at the lowest prices) from parties required to be listed in the register maintained under section 301 of the Act on account of the fact that the company finds such parties more reliable in terms of quality and/ or supply of goods. In a transaction of purchase, it is not necessary that purchases be made in all cases at the lowest rates. When the rates paid are higher than the prevailing market prices, the auditor has to use his judgement to determine whether the difference in rates is reasonable having regard to the other factors mentioned above. This may often be the case where the company wishes to have more than one source of supply or where there is limit to the manufacturing capacity of the supplier who quotes a lower price. Thus, the intention of the clause is to require the auditor to examine and comment on the reasonableness of the prices at which the transactions have been entered into.
- (d) A difficulty in judging the reasonableness of prices may also arise in cases where transactions are entered with sole suppliers. In such cases, the auditor may examine the reasonableness of prices paid with reference to list prices of the supplier concerned, other trade terms of the supplier, etc.
- (e) The auditor while reporting under this clause in circumstances outlined in

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paragraph (c) and (d) above should clearly bring out the reasons as to why no adverse comment was considered necessary.

60. *In case the company has accepted deposits from the public, whether the directives issued by the Reserve Bank of India and the provisions of sections 58A, 58AA or any other relevant provisions of the Act and the rules framed there under, where applicable, have been complied with. If not, the nature of contraventions should be stated; if an order has been passed by Company Law Board 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?* [Paragraph 4 (vi)]⁶

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 Tribunal⁷.
- (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.

⁶ The text of sections 58A and 58AA of the Act is reproduced in **Appendix X** to this Statement.

⁷ The term "Company Law Board" has been substituted by the term "National Company Law Tribunal" by the Companies (Second Amendment) Act, 2002.

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- (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

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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

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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 rules⁸.
- (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.

61. *In the case of listed companies and/or other companies having a paid-up capital and reserves exceeding Rs.50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crores rupees for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business. [Paragraph 4(vii)]*

⁸ The concept of materiality – which is fundamental to the entire auditing process—should be borne particularly in mind while reporting on this clause as in the case of other clauses of the Order.

Comments

- (a) This clause requires the auditor to comment whether the company has an internal audit system commensurate with the size and nature of the business. The clause is required to be commented upon by the auditor in case of companies having a paid-up capital and reserves exceeding rupees 50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crores rupees for a period of three consecutive financial years immediately preceding the financial year concerned. 'Financial year concerned' means the financial year under audit.
- (b) This clause has a mandatory application for the listed companies irrespective of the size of paid-up capital and reserves or turnover. It may be noted that the Order does not specify the date with reference to which the listing status of the company should be determined. In this regard, it is clarified that if the company is listed on a recognised stock exchange as on the date of the balance sheet, it should be considered as listed for the purpose of this clause. In respect of non-listed companies the clause is applicable only if:
 - (i) the paid-up capital and reserves of the company are more than rupees fifty lakhs as at the commencement of the financial year; or
 - (ii) average annual turnover exceeds rupees five crores for a period of three consecutive financial years immediately preceding the financial year concerned.
- (c) In other words, companies which have a paid-up capital and reserves of rupees fifty lakhs or less as at the commencement of the financial year as well as the companies which have an average annual turnover of rupees five crores or less for a period of three consecutive financial years immediately preceding the financial year concerned are excluded from the applicability of the clause.
- (d) It may be noted that the limit of rupees fifty lakhs applies to the total capital and reserves and not to merely the equity capital. Reference should also be made to paragraphs 17 to 19 of this Statement which specify the considerations for determination of limit of paid-up capital and reserves for determining the applicability of the Order to a private limited company.
- (e) While in respect of companies which are excluded, there is no necessity to make any specific mention in the audit report, the auditor would still be well-advised to make inquiries regarding internal audit since it forms an integral part of the system of internal control which the auditor normally

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examines as a part of the audit function.

- (f) The term "turnover" has been explained in paragraph 23 of this Statement. Reference may be made to the said paragraph for the meaning of the term "turnover" for the purposes of this Order.
- (g) A company may be covered by this clause on the turnover criterion in one year and may not be so covered in another year. Moreover, since average turnover of three financial years immediately preceding the financial year under audit is to be considered, it would follow that a company cannot be covered by this clause during the first three years of its operation on the basis of the turnover criterion. It may also be noted that the financial year may comprise of a period more or less than 12 months.
- (h) A company may either have its own internal audit department or entrust the work of internal audit to an outside agency. In the case of a group of concerns, it is also quite common to have a central internal audit department. The arrangement which is more suitable will depend upon the circumstances of each company but generally, where a company is small, it may find it expensive to have its own internal audit department staffed by personnel having the requisite qualifications.
- (i) The auditor has to examine whether the internal audit system is commensurate with the size of the company and the nature of its business. The following are some of the factors to be considered in this regard:
 - (i) What is the size of the internal audit department? In considering the adequacy of internal audit staff, it is necessary to consider the nature of the business, the number of operating points, the extent to which control is decentralised, the effectiveness of other forms of internal control, etc.

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

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- (vii) What is the follow-up? It is not sufficient that the internal audit system should point out errors in operation or deficiencies in the internal control system. It is equally necessary that there is an adequate follow-up system to ensure that the errors pointed out are corrected and remedial action taken on the deficiencies reported upon.
- (j) The auditor should examine the minutes of the meetings of the Board of Directors and audit committee, if any. These minutes would provide the auditor useful evidence regarding the efficiency and efficacy of the internal audit system.
- (k) It is important to note that the Act does not require a company to necessarily have an internal audit system. However, where such a system does not exist, the Order requires the auditor to mention the fact in his report. Moreover, since this part of the Order refers only to such companies which are either listed or companies having a paid-up capital and reserves in excess of rupees 50 lakhs or an average annual turnover in excess of rupees 5 crores for a period of three consecutive financial years immediately preceding the financial year concerned, it is desirable that such a company has an internal audit system.
- (l) It is equally important to note that the internal audit system is a part of the overall internal control system. Therefore, the scope of the internal audit and the extent of its coverage will, to some extent, depend upon the existence or otherwise of other forms of internal control. This is also a factor to be considered when evaluating the adequacy of the internal audit system.

62. *Where maintenance of cost records has been prescribed by the Central Government under clause (d) of sub-section (1) of Section 209 of the Act, whether such accounts and records have been made and maintained.*
[Paragraph 4(viii)]

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

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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.

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- (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.

63. *Is the company regular in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Employees' State Insurance, Income-tax, Sales-tax, Wealth Tax, Service Tax, Custom Duty, Excise Duty, Cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor. [Paragraph 4(ix)(a)]*

Comments

- (a) 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

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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 installments, 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

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warehouse, the payment of import duty is to be made when the goods are removed from the bonded warehouse. Till the time⁹ 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. However, till the time such Rules are prescribed, the auditor need not make any comment in respect of the Cess under section 441A of the Companies Act, 1956 in his report under paragraph 4(ix)(a) of CARO 2003¹⁰.~~

⁹ It may be noted that section 62 of the Customs Act, 1962 provides that any goods deposited in the warehouse may be stored upto a period of one year in the bonded warehouse. The time limit is five years in case of capital goods intended for use in any 100% EOU. The said Act, however, also provides for extension of the warehousing period by the relevant authorities subject to certain prescribed conditions.

¹⁰ The Council of the ICAI, at its 312th meeting held in December 2011, considered the statutory auditor's reporting responsibilities in respect of depositing of Cess pursuant to Clause 4(ix)(a) of the Companies (Auditor's Report) Order, 2003 and decided to modify the same as indicated above. The complete text of the Announcement issued regarding this decision of the Council is published as Annexure to this Statement. Readers are requested to refer to the complete text of this Announcement.

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- (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

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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.¹¹
- (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

¹¹ This concept of materiality – which is fundamental to the entire auditing process – should be borne in mind while reporting on this clause as in case of other clauses of the Order.

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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. The following are examples of the wordings, which may be used in relevant situations:
 - “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”.

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“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:

Statement of Arrears of Statutory Dues Outstanding for More than Six Months

<i>Name of the Statute</i>	<i>Nature of the Dues</i>	<i>Amount (Rs.)</i>	<i>Period to which the amount relates</i>	<i>Due Date</i>	<i>Date of Payment</i>
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64. *In case dues of Income Tax/ Sales Tax/ Service Tax/ Customs Duty/ Wealth Tax/ Excise Duty/ Cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned. [Paragraph 4(ix)(b)]*

{A mere representation to the Department shall not constitute the 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

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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

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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:

Statement of Disputed Dues

<i>Name of the Statute</i>	<i>Nature of the Dues</i>	<i>Amount (Rs.)</i>	<i>Period to which the amount relates</i>	<i>Forum where dispute is pending</i>
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- (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.

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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".

65. *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.*
[Paragraph 4(x)]

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

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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.

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

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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 upto 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 institutions¹², 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

¹² Reference may be made to paragraph 22 of the Statement, which describes "financial institutions" for the purpose of the Order.

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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.”

67. *Whether adequate documents and records are maintained in cases where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities; If not, the deficiencies to be pointed out. [Paragraph 4 (xii)]*

Comments

- (a) The clause requires the auditor to comment on the adequacy of documents and records maintained in cases where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities. If the auditor is not satisfied about the adequacy of documents and records, he has to report the inadequacies and point out deficiencies in maintenance of records.
- (b) This requirement is confined to loans and advances which are secured by way of pledge of shares, debentures and other securities, and does not

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extend to other forms of security, e.g., hypothecation, guarantee, etc.

- (c) Pledge implies that the physical possession of the security must be transferred to the company along with a power to sale of the security in the case of default. This transfer can be actual or constructive. For example, the share or debenture may be physically in the custody of the company or it may be with a person like a bank which holds it on behalf of the company.
- (d) A question may arise as to the exact meaning of the term “other securities”. The term, ‘other securities’ may be construed to mean bonds or promissory notes issued by a government or semi-government authority. In a broader sense, it can include any other asset which is given as security for repayment of a loan or fulfillment of an obligation. However, the term ‘other securities’ is used along with shares and debentures and, therefore, for the purpose of this clause, consideration will have to be confined to securities which are similar to shares or debentures.
- (e) The auditor has to report whether adequate documents and records have been maintained. What records would be considered adequate depends upon the nature of the security and the party to whom the loan or advance is granted. But the records should generally include the following particulars:
 - (i) the full name and address of the borrower;
 - (ii) the amount of the loan or advance;
 - (iii) stipulations regarding period of repayment, the rate of interest, the security to be pledged and all other terms of the loan or advance;
 - (iv) the record of the disbursements, repayments towards the loan or advance and recovery of the interest;
 - (v) full particulars of the security pledged, for example, if the security consists of shares, the particulars would include the names of the companies, number of shares, class of shares, distinctive numbers of the shares, particulars of the parties in whose names the shares stand, etc.;
 - (vi) the documents needed to transfer the ownership of the security in case of need;
 - (vii) periodical acknowledgements from the parties confirming the balances due;

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(viii) proof that the party has power to borrow, e.g., in case the borrower is a company, its memorandum of association, board resolution or shareholders' resolution; etc.

(f) The clause does not cast a duty upon the auditor to examine the adequacy of the security on the basis of which loans have been granted. This may be due to the fact that an inquiry in this regard has to be made by the auditor in terms of section 227 (1A) of the Act. In any event, it remains the duty of the auditor to ensure by physical verification that, where a loan or advance is given on the basis of a pledge of shares, debentures or other securities, the securities are in the custody of the company and that the market value of the securities is adequate to cover the outstanding amount of the loan and interest. The auditor should also physically verify the securities pledged by reference to either the physical securities or statements from depository participants. In the case of securities in dematerialized form, the auditor should also obtain sufficient appropriate audit evidence that the company has a valid right to sell the shares kept as security in the case of a default from the borrower. There may be several ways with which the auditor can verify the said right of the company, for example, the auditor may obtain a certificate to this effect from the depository participant.

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

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

Comments

(a) The clause requires the auditor to comment whether the provisions of any special statute applicable to chit fund have been complied with. It may be noted that clause is required to be commented upon by the auditor only in case of a chit fund company. Therefore, the auditor should determine whether the company is carrying on the chit fund business. It may be noted that the Order contains a single definition of the terms "chit fund company", "*nidhi* company" or "mutual benefit company". According to the Order, "chit fund company", "*nidhi* company" or "mutual benefit company" means a company engaged in the business of managing, conducting or supervising as a foreman or agent of any transaction or

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

- (b) Though the Order defines the terms “chit funds”, “*nidhis*” and “mutual benefit society” using a single definition but these entities are governed by different laws and regulations and different meanings have been attached to these terms under the relevant laws and regulations. For example, a chit fund company is a company that carries on the business of chit funds within the meaning of the Chit Funds Act, 1982. Clause (b) of section 2 of the Chit Funds Act, 1982 defines the “chit” as a transaction whether called chit, chit fund, *chitty kuri* or by any other name by or under which a person enters into an agreement with a specified number of persons that every one of them shall subscribe a certain sum of money (or a certain quantity of grain instead) by way of periodical instalments over a definite period and that each such subscriber shall, in his turn, as determined by lot or by auction or by tender or in such other manner as may be specified in the chit agreement, be entitled to the prize amount. Explanation to the clause provides that a transaction is not a chit within the meaning of this clause, if in such transaction:
- (i) some, but not all, of the subscribers get the prize amount without any liability to pay future subscriptions; or
 - (ii) all the subscribers get the chit amount by turn with a liability to pay future subscriptions.
- (c) This is a very wide requirement and taken literally would mean that the auditor has to ensure that the company complies with all the requirements of the relevant special statutes. Obviously, this cannot be the intention. A more rational interpretation would, therefore, be that the auditor has to satisfy himself and report that the company has complied with all the provisions of the special statutes in so far as they are applicable to the accounts of the chit fund company. It is necessary that the audit report should clearly state the above interpretation. The following is an example of the report:

“According to the information and explanations give to us, the company has complied with the provisions of in so far as those provisions are applicable to the accounts under report.”

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- (d) It may also be noted that special statutes applicable to chit fund companies vary from State to State. This is because of the fact that the Central Government enacted the Chit Funds Act, 1982 (Act No. 40 of 1982) which extends to the whole of India except the State of Jammu and Kashmir. According to section 1(3) of the Chit Funds Act, 1982, it comes into force on such date as the Central Government may, by notification in the official gazette, notify and also that different dates may be notified for different States. So far, the Central Government has notified the date of the Chit Funds Act, 1982 coming into force in respect of certain States and Union Territories only¹³. In respect of States and Union Territories for which no date for the Chit Funds Act, 1982 coming into force has been notified, the respective States/Union Territories have either enacted relevant Act and rules in this regard or have adopted the Chit Funds Act, 1982 as it is. The auditor should obtain an understanding of the relevant Acts and the rules which are applicable to the company situated in a particular State/Union Territory. It may also happen that the company's branches may be situated in more than one State, in which case, the provisions of different States' Acts and rules may be applicable to the respective branches/offices.

69. *In respect of nidhi/mutual benefit fund/societies:*

- (a) *whether the net-owned funds to deposit liability ratio is more than 1:20 as on the date of balance sheet;*
- (b) *whether the company has complied with the prudential norms on income recognition and provisioning against sub-standard/doubtful/loss assets;*
- (c) *whether the company has adequate procedures for appraisal of credit proposals/requests, assessment of credit needs and repayment capacity of the borrowers;*
- (d) *whether the repayment schedule of various loans granted by the nidhi is based on the repayment capacity of the borrower. [Paragraph 4(xiii) Second Part; sub-clauses (a) to (d)]*

Comments

- (a) The sub-clause (a) requires the auditor to report whether, in the case of a

¹³ The States and Union Territories for which the dates have been notified by the Central Government are Karnataka, West Bengal, Tamil Nadu, Chandigarh, Dadra and Nagar Haveli, Lakshadweep, Himachal Pradesh, Sikkim, Andaman and Nicobar Islands, Orissa, Goa, Daman and Diu, Madhya Pradesh, Madhya Pradesh, Pondichery, Meghalaya, Uttar Pradesh, Rajasthan, Bihar and Punjab.

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nidhi and mutual benefit society, net-owned funds to deposit liability ratio is more than 1:20 as on the date of balance sheet.

- (b) It may be noted that “*nidhis*” or “mutual benefit societies” are the companies which are notified by the Central Government to be a “*nidhi*” or a “mutual benefit society” under section 620A of the Act. It may also be noted that a company which is declared as a “*nidhi*” or a “mutual benefit society” by the Central Government under section 620A cannot carry on the business of chit fund, hire purchase finance, leasing finance, insurance or acquire shares or debenture issued by any body corporate except the shares of another “*nidhi*”, unless specifically permitted by the Central Government.
- (c) It may be noted that a “*nidhi*” or a “mutual benefit society” may accept deposits not exceeding twenty times of its net owned funds as per last audited balance sheet¹⁴.
- (d) According to the directions issued by the Central Government vide notification number GSR 555(E) dated 26th July, 2001 [as modified by notification number GSR 308(E) dated 30th April, 2002], the term “net owned funds” means the aggregate of paid-up equity capital and free reserves as reduced by accumulated losses and intangible assets appearing in the last audited balance sheet of the company. A reserve is considered as a “free reserve” if it is available for distribution as dividend. Further, the amount representing the proceeds of issue of preference shares shall not be included for calculating net-owned funds. However, for *nidhis* or mutual benefit societies existing on or before 26th July, 2001, the proceeds of issue of preference shares shall be included for calculation of net-owned funds up to the financial year 31st March 2004.
- (e) A *nidhi* or a mutual benefit society can accept fixed deposits, recurring deposits accounts and savings deposits from its members in accordance with the directions notified by the Central Government. The aggregate of such deposits is referred to as “deposit liability”.
- (f) The auditor should ask the management to provide the computation of the deposit liability and net-owned funds on the basis of the requirements contained herein above. This would enable him to verify that the ratio of deposit liability to net owned funds is in accordance with the requirements prescribed in this regard. The auditor should verify the ratio using the

¹⁴ Directions issued by the Central Government vide notification number GSR 555(E) dated 26th July 2001.

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figures of net owned funds and deposit liability computed in accordance with what is stated above. The comments of the auditor should be based upon such a statement provided by the management and verification of the same by the auditor.

- (g) The sub-clause (b) requires the auditor to state whether, the company has complied with the prudential norms on income recognition and provisioning against sub-standard/doubtful and loss assets. This requirement is in addition to the audit procedures that the auditor normally performs in respect of advances for obtaining evidence on the assertions about their existence, completeness, valuation and disclosure.
- (h) *Nidhis* and mutual benefit societies can give loans to its shareholders or members against the security of gold, silver, jewellery, immovable property, fixed deposit, kisan vikas patra, national savings certificates, insurance policies and other Government securities. The Central Government, *vide* notification number GSR 309 (E) dated 30th April 2002 issued prudential norms for revenue recognition and classification of assets in respect of mortgage or loans. The text of the Circular is reproduced in **Appendix XII** to the Statement¹⁵.
- (i) The auditor should examine whether the prudential norms for revenue recognition and classification of assets have been complied with by the *nidhi* or mutual benefit society in the preparation and presentation of the financial statements. However, these norms should be construed as laying down the minimum provisioning requirements and wherever a higher provision is warranted in the context of the threats to recovery, such higher provision can be made. If a company makes such higher provision, it should not be construed that the company has not complied with the prudential norms. Where the *nidhi* or the mutual benefit society has not complied with the prudential norms, the auditor should state the fact while reporting on the clause.
- (j) The sub-clause (c) requires the auditor to comment upon whether the company has adequate procedures for appraisal of credit proposals/requests, assessments of credit needs and repayment capacity of the borrowers. The auditor should study the procedures regarding appraisal of credit proposals/requests, assessment of credit needs and repayment capacity of the borrowers. It may so happen that a company might have a separate set of procedures for appraisal of credit proposals/requests of employees. The auditor should also study the

¹⁵ The directions issued by the Government of India are subject to change from time to time.

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same. Such procedures should normally include steps to be followed for detailed verification of the proposal to assess need of credit and the repayment capacity of the borrower. Study of the individual borrower files would indicate whether proper systems and procedures have been followed. Based on his assessment, the auditor has to form an opinion about the adequacy of procedures in the credit department and accordingly comment on this clause. The auditor can gather the requisite evidence by examining relevant documents (such as loan application forms, supporting documentation, sanctions, security documents, etc.) and by obtaining information and explanations from the management in appropriate cases.

- (k) The sub-clause (d) requires the auditor to comment on whether the repayment schedule of various loans granted by the *nidhi* is based on the repayment capacity of the borrower. It may be noted that the scope of the auditors' enquiry for this clause is limited to examination of the documentation available with the company in regard to grant of loans. Based on his examination of the documentation in regard to grant of loans, the auditor would form an opinion whether the repayment schedule of various loans granted by the *nidhi* is based on the repayment capacity of the borrower. Where the number of loans granted by the company is very large, it is obviously not feasible for the auditor to satisfy himself that every single loan's repayment schedule granted by the *nidhi* is based on the repayment capacity of the borrower. It is important to note that the auditor's comments on this clause would have to be based on the auditor's examination of the documentation of all large loans, say, exceeding a particular limit determined by the auditor having regard to the concept of materiality and a test check of the documentation of other loans with a view to determine that the repayment schedule of various loans granted by the *nidhi* is based on the repayment capacity of the borrower.
- (l) There could be several cases where the auditor may come to a conclusion that the repayment schedule of a particular loan is not based on the repayment capacity of the borrower, the same should be reported by the auditor under this clause.

70. *If the company is dealing or trading in shares, securities, debentures and other investments, whether proper records have been maintained of the transactions and contracts and whether timely entries have been made therein; also whether the shares, securities, debentures and other investments have been held by the company, in its own name except to the extent of the exemption, if any, granted under section 49 of the Act. [Paragraph 4(xiv)]*

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Comments

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

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properly written up and preserved. The adequacy of the records has to be tested in the light of their ability to give details of (i) purchases and sales and the profit or loss arising on sale, (ii) the stock of investments and their valuation, and (iii) the amounts due for sales and payable for purchases. Some of the features to be examined in this connection would be the following:

- (i) Details regarding the purchase and sale, that is, the particulars about the person from whom or to whom the purchase or sale was made, the rate at which the purchase or sale was made, the number of shares or other investments with full details regarding class, distinctive numbers, number of certificates, etc., and the document, for example, bought note or sale note evidencing the sale.
 - (ii) The adjustment, if any, necessary when securities are purchased or sold and whether the quotations are exclusive of interest accrued or, when shares are purchased or sold ex-dividend whether dividend has to be paid or received.
 - (iii) The details of holdings in individual companies, the classes of investments (e.g., equity shares, preference shares, debentures, etc.), the basis on which the closing stock is valued and the profit or loss on sale is to be computed.
 - (iv) The recording of shares received as bonus shares; the accounting of rights subscribed for or sold.
 - (v) The individual accounts of the parties from whom moneys are due for sale or to whom moneys are payable for purchases and the settlements made there against.
- (e) The auditor is also required to examine whether timely entries are made in the records. This may be done by one or more of the following methods:
- (i) a surprise inspection of the records;
 - (ii) an examination of the system of internal control with particular reference to the manner in which and the time at which entries are made in the records; and
 - (iii) an examination of the internal audit reports to ensure if the programme of internal audit specifically covers an inspection of the records to determine whether entries are made in time.
- (f) Section 49 of the Act requires that all investments have to be made and

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held in the company's own name. The exemptions provided by the section are:

- (i) where a person is appointed as a nominee of the company on the board of directors of another company and such nominee is required to hold qualification shares, then to the extent of such qualification shares;
 - (ii) where a company has a subsidiary and it is necessary to ensure that the number of members of the subsidiary is not reduced below seven in the case of a public company and two in the case of a private company;
 - (iii) in the case of a company whose principal business consists of the buying and selling of shares or securities;
 - (iv) in the case of investments deposited with a bank for collection of dividend or interest or for transfer into such bank's name to facilitate transfer; and
 - (v) in the case of investments pledged as security for loans or for performance of obligations.
- (g) The auditor is required to report whether the investments are held in the company's own name in respect of companies which deal or trade in investments. However, section 49(4) specifically exempts companies whose principal business is the buying and selling of shares or securities from that requirement. It seems, therefore, that the requirement to report will arise when the buying and selling of shares or securities is not the principal business of the company but it does such business along with some other business.
- (h) When a company deals or trades in investments it is possible that investments which are intended or contracted to be sold immediately may not have been transferred to the company's own name. The auditor should, therefore, use his discretion to ascertain whether, in the circumstances of each case, the failure to transfer the investments to the company's name is understandable.

71. *Whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and conditions whereof are prejudicial to the interest of the company.* [Paragraph 4 (xv)]

Comments

- (a) The clause requires the auditor to determine whether the company has

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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

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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.

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

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 pre-determined 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". Term 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

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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

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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 fag 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 auditor, in such cases, should verify that the company has not invested or utilized 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.

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

Comments

- (a) The principles of financial management suggest that the long-term assets of an enterprise should be financed from long-term funds. The genesis of the principle is that if funds raised from short-term sources are used for long-term investments, the enterprise can face liquidity problems as soon as the short-term sources fall due for payment. However, an exception to the principle would be the situation where an enterprise is able to generate sufficient funds from long-term sources either through its operations or other means to meet the working capital requirements arising from the event of short-term sources falling due for payment. The application of the principle is considered to be of utmost importance for the financial health of an enterprise. The clause requires the auditor to

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comment whether the funds raised on short-term basis have been used for long-term investment, so that the readers can assess whether the company has followed the above-mentioned principle of financial management. Examples of use of funds raised on short-term basis and used for long-term purposes would include investing money from overdraft facilities in long-term investments in shares of subsidiaries/associates/joint ventures or investing money raised from public deposits due for repayment in three years in a project whose pay back period is ten years. Further, cash from operating activities represent a long term source of funds.

- (b) The auditor uses the data contained in the balance sheet to ascertain whether the funds raised on short-term basis have been used for long-term investment. Short-term sources of funds include temporary credit facilities like cash credits, overdraft. Reduction in current assets or increase in current liabilities are also sources of short-term increase in funds. Long-term application of funds includes investment in fixed assets, long-term investments in share, debentures and other securities and other assets of similar nature, repayment of long-term loans and advances or redemption of long-term debt or securities, etc. Application of funds which is not long-term may be categorised as the short-term application. Increase in current assets or decrease in current liabilities also indicate short-term application of funds.
- (c) The auditor should determine the long-term sources and the long-term application of funds by a company using the data contained in the financial statements. It should also be noted that the clause requires the auditor to state whether the company has utilized short-term funds for long-term application. It should be noted that funds, whether generated from long-term sources or short-term sources, would, generally, result in an increase in current assets—whether in the form of increase in cash and bank balances or may be in the form of increase in receivables, etc. If the quantum of long-term funds of a company is not significantly different from the long-term application of funds, it is an indication that the long-term assets of the company are financed from the long-term sources. However, if the quantum of long-term funds is significantly less than the long-term application of funds, it is an indication that short-term funds have been used to finance the long-term assets of the company. The difference between the figures of long-term funds and long-term assets of the company indicate the extent to which short-term funds have been used to finance long-term assets of the company.
- (d) Working capital is normally understood to be a short-term application of

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funds which keeps on changing its form throughout the working capital cycle. It may, however, be noted that core or permanent working capital of an enterprise should be financed from long-term funds (preferably the owners' capital). Core or permanent working capital is that component of the working capital of the enterprise that always remains invested in business and is never allowed to exit. Therefore, if the quantum of long-term funds is significantly more than the long-term application of funds, the auditor should determine whether long-term funds have been used to finance the core working capital of the company. For this purpose, the auditor should compute the figure of working capital and compare it with the difference between the quantum of long-term funds and long-term applications of funds. Still, if the long-term funds are more than the working capital of the company the auditor's report should state that the company has used long-term funds to finance current assets.

- (e) Certain companies deploy funds based on their respective maturity pattern as a risk management technique. In case a company does so, it would be easier for the auditor to comment upon the clause since a comparison of sources of funds with their deployment based on their respective maturity patterns would be a significantly more sophisticated way of analysing whether short-term funds have been used to finance long-term assets of the company. To take a highly simplified example, if an enterprise has a long term debt that is to mature within the next 12 months and an equivalent amount in a long-term investment that would mature after 3 years, the maturity pattern analysis would indicate the potential inability to meet the liability on the debt on due date, but the traditional analysis would not do so.
- (f) The clause also requires the auditor to state the nature of application of funds if the company has financed long-term assets out of short-term funds. The nature of application of funds can be determined only if the funds raised can be directly identified with an asset. The determination of direct relationship between particular funds and an asset from the balance sheet may not be feasible. Further, such movement in funds should be supported by relevant documentation. A more practical approach would be to determine the overall picture of the sources and application of funds of the company unless an evident trail is available that enables the auditor in establishing a direct relationship between sources and applications of funds.
- (g) Another question that arises in this context is whether this clause is relevant in the case of branches of Indian companies. There are a number of clauses in the Order, which can be properly answered only in

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the context of the company as a whole, for example, the clause relating to preferential allotment of shares. Similarly, the clause relating to use of funds should also be evaluated in the context of the enterprise as a whole and the branch auditor may merely state that the clause is not relevant at the branch level. However, in the case of a branch of a foreign company, this clause would be applicable.

- (h) An example of reporting under the clause is as follows:

“According to the information and explanations given to us and on an overall examination of the balance sheet of the company, we report that no funds raised on short-term basis have been used for long-term investment by the company.”

- (i) An example of negative reporting under the clause is as follows:

“According to the information and explanations given to us and on an overall examination of the balance sheet of the company, we report that the company has used funds raised on short-term basis for long-term investment. The company has accepted public deposits amounting to rupees 5 crores which would fall due for repayment two years from the date of their acceptance. The company has invested the money for the increase of the production capacity which would be completed in the next four years.”

74. *Whether the company has made any preferential allotment of shares to parties and companies covered in the Register maintained under Section 301 of the Act, and if so whether the price at which shares have been issued is prejudicial to the interest of the company.* [Paragraph 4 (xviii)]

Comments

- (a) The clause requires the auditor to report whether the company has made any preferential allotment of shares to parties and companies covered in the register maintained under section 301 of the Act. Further, if the company has made any preferential allotment of shares to such parties, the auditor has to give his opinion whether the price at which shares have been issued is prejudicial to the interest of the company.
- (b) It may be noted that the term “preferential allotment” is not defined under the Act. It may also be noted that the clause requires the auditor to report on the preferential allotment only in the case of shares issued by the company and not on preferential allotment of other securities issued by the company. The term “shares” includes both equity as well as

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preference shares. For the purpose of this clause, preferential allotment of shares would mean an allotment of shares to parties and companies covered in the register maintained under section 301 of the Act in preference to others. The preference can be with regard to the price or other terms and conditions associated with the allotment.

- (c) In the case of a listed company, preferential allotment of securities is governed by the SEBI (Disclosure and Investor Protection) Guidelines, 2000. A listed company can make preferential issues of equity shares, fully convertible debentures, partly convertible debentures or any other instrument which may be converted into or exchanged with equity shares at a later date. A listed company can issue shares on a preferential basis at a price not less than the higher of the following:
 - (i) the average of the weekly high and low of the closing prices of the related shares quoted on the stock exchange during the six months preceding the relevant date;
 - or
 - (ii) the average of the weekly high and low of the closing prices of the related shares quoted on a stock exchange during the two weeks preceding the relevant date.
- (d) In the case of a listed company, if the pricing of the shares issued in a preferential allotment is in accordance with the requirement of the Guidelines laid down in this regard by the Securities and Exchange Board of India, the auditor may conclude that the price at which shares have been issued is not prejudicial to the interest of the company. In such a case, the auditor should gather sufficient appropriate audit evidence that the company has complied with the Guidelines issued by the Securities and Exchange Board of India in this regard.
- (e) It is also important to consider the question whether the clause applies to issue of shares under the Employees Stock Option Scheme by private companies constitute preferential allotment for the purposes of this clause. As has been mentioned in the foregoing paragraphs, in the case of a listed company, if the pricing of the shares issued in a preferential allotment is in accordance with the requirement of the Guidelines laid down in this regard by the Securities and Exchange Board of India, the auditor may conclude that the price at which shares have been issued is not prejudicial to the interest of the company. Thus, as far as a listed company is concerned, only preferential allotment of shares covered under the SEBI (Disclosure and Investor Protection) Guidelines 2000, is

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to be examined. In the case of a private company and an unlisted public company, the auditor would have to examine whether the price at which the company has made the preferential allotment of shares is prejudicial to the interest of the company. In so far as the price at which preferential allotment is made is concerned, it may be noted that valuation of shares of a company involves use of judgment, knowledge of the business, analysis and interpretation and the use of different methods, which may result in assigning different values based on different methods. There are certain basic factors, which affect the value of a company's shares for which the price calculated is adjusted. The factors are earnings, dividends declared, asset value and goodwill of the company¹⁶. Methods generally used for determining the fair value of the business by the company, which take into consideration one or more factors mentioned above are:

- (i) Net Assets Basis – considers the valuation of assets, subtracting therefrom liabilities, etc., to arrive at the value of the equity shares.
 - (ii) Maintainable Profits Basis – this is based on the future maintainable profits/earnings of the company.
 - (iii) Yield Basis – this method recognises the yield/dividends as a base for arriving at the fair value of the shares.
 - (iv) Discounted Cash Flow Method – this method estimates the value of shares by estimating the future cash flows from operations and discounting the cash flows at a specified rate.
- (f) It is not rare to find a combination of different methods used in the context of valuation of shares; for example, an averaging of maintainable profits basis and the net assets basis.
- (g) The auditor should examine the method used for valuation of shares of the company and should also ascertain the reasonableness of the assumptions underlying the calculation. If necessary, the auditor may use the services of an expert. Whether the price of the shares for preferential allotment is prejudicial to the interests of the company is a question that would require the use of professional judgement by the auditor. The auditor should give due consideration to the factors which affect the value of a company's shares for which the price calculated is

¹⁶ This is not an exhaustive listing of the factors influencing the price of the shares. There could be numerous other factors like the nature of the company's business, the caliber of managerial personnel, prospects of expansion, financial structure, cash flows, patents, franchises, incidence of taxation, competition, size of the holding, government policy, prevailing political climate, risk of obsolescence of items manufactured, etc., may also affect the price of the shares of a company.

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adjusted. Some of the main factors are mentioned at paragraph (e) above. On an examination of the methods and various factors, the auditor may come to a conclusion that better price for the shares issued could have been obtained if the difference between the price that could have been obtained and that has actually been received by the company is so significant that no reasonable person would have allotted shares at the price at which the preferential allotment has actually been made. The auditor should also obtain a representation from the management as to why the company considers that the price of the shares issued under preferential allotment is not prejudicial to the interest of the company. If the auditor does not find the explanation convincing, it will be necessary for him to state that the price at which preferential allotment of shares has been made by the company is prejudicial to the interest of the company.

- (h) Companies sometimes do make allotment of shares based on the valuation reports issued by experts in this field. While the auditor uses the report of an expert to determine whether the price for the preferential allotment of share is not prejudicial to the interest of the company, the auditor should also comply with the requirements of Standard on Auditing (SA) 620, "Using the Work of an Expert".
- (i) In case, the company has made preferential issue of shares by passing an ordinary resolution under clause (b) of sub-section (1A) of section 81 of the Act, apart from examining the method used for valuation of shares of the company and ascertaining the reasonableness of the assumptions underlying the calculation, the auditor should also examine the Order of the Government as to its satisfaction that the proposal is most beneficial to the company. Where the Government is satisfied in this regard, the auditor need not make his assessment as to the reasonableness of the prices of the shares for the preferential allotment of shares. The auditor, however, is not precluded from doing so. If the auditor forms his opinion on the basis of the Order issued by the Government, he should state the fact of his reliance on the Government Order for the purpose of reporting.

75. *Whether security or charge has been created in respect of debentures issued?* [Paragraph 4(xix)]

Comments

- (a) The auditor, under this clause, is required to examine whether the company has created any 'security' or 'charge' for the debentures issued by it. The auditor is required to comment upon the creation of security or charge in respect of debentures issued by the company by creating

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proper charges on the assets of the company.

- (b) Where the company has issued any debentures, the auditor should also examine the debenture trust deed executed under section 117A of the Act. The auditor should pay particular attention to verify whether proper security has been created in favour of the debenture trust. The security creation can be verified by examining the relevant documents creating the charge in favour of the trustees for the debentureholders duly registered in the concerned Registrar's office if the security is an immovable property. Readers' attention is also invited to the Guidance Note on Certification of Documents for Registration of Charges issued by the Institute of Chartered Accountants of India.
- (c) If the debentures have been issued towards the end of the year and the securities are created subsequently then, to present a complete and balanced picture while reporting the fact that the security in respect of debentures is yet to be created, the auditor would be well advised to also mention the reason for the same, viz., that the debentures have been issued only recently (specify the month of issue) and that the company is taking steps to create the security. However, he should report as above only where, as a result of his enquiries, he is satisfied that the non-creation of security is not due to deliberate or inadvertent delay on the part of the company and that it is in fact in the process of creation of security.
- (d) If the company has not created any security, the auditor should report the fact in his report.

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

Comments

- (a) In case the company has made a public issue of any of its securities like shares, preference shares, debentures and other securities, the auditor is required to report upon the disclosure of end-use of the money by the management in the financial statements. The auditor is also required to state whether he has verified the disclosure made by the management in this regard.
- (b) Currently, there is no legal requirement under the Act to disclose the end use of money raised by public issues in the financial statements. The companies, however, make such a disclosure in the Board's Report. Schedule VI to the Act requires that only unutilized amount of any public issue made by the company should be disclosed in the financial

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statements of a company. In the absence of any legal requirement of such disclosure, it appears that the clause envisages that the companies should disclose the end use of money raised by the public issue in the financial statements by way of notes and the auditor should verify the same.

- (c) It may also be noted that according to the SEBI (Disclosure & Investor Protection) Guidelines, 2000, in case the issue exceeds Rs. 500 crores, the issuer company is required to make arrangements for the use of proceeds of the issue to be monitored by financial institutions. The monitoring agency so appointed is required to submit its report to the SEBI, on a half-yearly basis, till the completion of the project. In case, the company has appointed a monitoring agency for the purpose of the issue, reports of the monitoring agency would also be helpful to the auditor while reporting under the clause.
- (d) 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 funds raised through public issues for the stated purpose, the funds were temporarily used for the purpose other than for which they were raised but were ultimately utilised for the stated end-use.
- (e) Normally, the companies do mention the end-use of the money proposed to be raised through the public issues in the prospectus. An examination of the prospectus would provide the auditor an understanding of the proposed end-use of money raised from public. The auditor should verify that the amount of end-use of money disclosed in the financial statements by the management is not significantly different from the proposed and actual end use. The auditor should obtain a representation from the management as to the completeness of the disclosure with regard to the end-use of money raised by public issues. If the auditor is of the opinion that adequate disclosure with regard to end use of money raised by public issue has not been made in the financial statements, the auditor should state the fact in his audit report. If, for any reason, the auditor is not able to verify the end-use of money raised from public issues, he should state that he is not able to comment upon the disclosure of end-use of money by the company since he could not verify the same. He should also mention the reasons which resulted in the auditor's inability to verify the disclosure.

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- (f) It may be noted that while reporting under this clause, the auditor should also have regard to the SEBI (Disclosure and Investor Protection) Guidelines, which contain a number of disclosure requirements in the balance sheet with respect to utilization of proceeds of monies raised from public, whether by shares or debentures, as also disclosure requirements in respect of unutilized monies from such proceeds. From a perusal of the above mentioned Guidelines of SEBI, it would be apparent that the details have to be given of both 'utilised' and 'unutilised' monies. Since the purpose is to provide a picture to the reader of 'utilisation of issue proceeds', it is only logical that the sum total of utilised and unutilised portions equal the total issue size. This implies that the figure of 'utilised' money should be cumulative. A company can, however, present greater details by showing the break-up of year-end cumulative figures into opening figures and monies utilised during the year.
- (g) Another point to consider with respect to this clause is whether it applies to monies raised from capital markets through ADR route. It may be noted that neither the Order nor the Act contains the definition of 'public issue'.

SEBI (Disclosure and Investor Protection) Guidelines define a public issue as "an invitation to public to subscribe to the securities offered through a prospectus".

It seems that strictly in terms of the above guidelines, monies raised from foreign capital markets may not fall within the scope of the term 'public issue' as defined above. The Guidelines seem to be in the context of issues to Indian public. For example, one of the mandatory requirements is to have collection centres in the four metropolitan cities. It can be argued that for a company raising funds on a foreign capital market, this requirement would be redundant or out of context.

On the other hand, it can also be argued that since depository receipts issued pursuant to capital issue in a foreign market are convertible into normal listed securities of the company, effectively their issuance is equivalent of issuance of securities to public in India. Further in case a project is financed partly from Indian public issue and partly from ADR, it would be difficult to argue that the utilisation of only Indian issue proceeds should be given. The auditor should adopt this view as, in any case, that would result in meeting the intent behind the clause.

77. *Whether any fraud on or by the company has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.*
[Paragraph 4(xxi)]

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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:

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- ◆ 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

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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

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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.

Form of Report

78. The Order requires that the auditor should make a statement on all the matters contained therein. This requirement applies even where the answers to any of the questions are unfavourable or qualified. The Order further provides that where an auditor is unable to express any opinion, he should indicate such fact. The auditor is also required to give reasons for any unfavourable or qualified answer or for his inability to express an opinion on any of the matters specified in the Order.

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

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

However, In the case of companies which have been exempted from the applicability of the Order unconditionally i.e., banking companies, insurance companies; and companies licensed to operate under section 25 of the Act, the auditor need not mention anything about the exemption from the applicability of the Order in his report. However, in the case of a private limited company it would be appropriate for the auditor to mention in this report that the company is exempted from the applicability of the Order.

80. There may be situations where one or more of the clauses are not applicable. For example, the requirement regarding internal audit system does not apply in case of all the companies. In such situations, it would be appropriate for the auditor to make a suitable comment in his report bringing out the fact of

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non-applicability of a particular clause. To illustrate, where the maintenance of cost records has not been prescribed by the Central Government under section 209(1)(d) of the Act, the auditor may state:

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

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

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

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

83. It is suggested that the sequence of the items as appearing in the report should be: first, the comments, if any, under sub-section (1A); second, the comments under the Order; and finally, the report under sub-sections (2), (3) and (4) of section 227. The comments under the Order may, alternatively, be given in

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the form of an Annexure to the report. However, when the comments are given in an Annexure, it is necessary to refer to the Annexure in the main report and it is advisable to sign the Annexure in addition to signing the main report.

84. If any of the comments on matters specified in the Order are adverse, the auditor should consider whether his comments have a bearing on the true and fair view presented by the financial statements and, therefore, might warrant a modification in the report under sub-sections (2), (3) and (4) of section 227. For example, in case where a company has disposed off a substantial part of fixed assets and consequently the going concern assumption is not resolved, the auditor apart from giving an appropriate comment under the Order, should also make a suitable qualification in the audit report on the financial statements. Another example of such a situation would be a case where a *nidhi* or a mutual benefit society has not complied with the prudential norms for revenue recognition and classification of assets. Another example in this regard would be of a situation where the company has used funds raised on short-term basis have been used for long-term purposes. It may be noted that fixed term borrowings approaching maturity without realistic prospects of renewal or repayment is an indication of risk that the going concern assumption may no longer be appropriate. In such a situation, the auditor would have to comply with the requirements of SA 570, "Going Concern".

85. If the auditor is of the opinion that any of the adverse comments on matters specified in the Order results in a qualification under sub-sections (2), (3) and (4) of section 227 the auditor may prefer to preface his report under those sub-sections by stating the qualification(s). Such a qualification(s) should be made against the specific item which is being qualified.

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

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

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

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

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

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

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

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

or

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

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

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

91. Similar considerations would apply when the auditor is unable to express an opinion. For example, if the internal audit department is unable to produce any audit programme, working papers, report, or other evidence of work done, the auditor may not be in a position to report whether the system is

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commensurate with the size and nature of the business of the company. In such circumstances, he should clearly state that he is unable to express an opinion because such records or evidence have not been produced before him.

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

93. Section 227(3)(e) of the Act requires that the auditor's report should also state in thick type or in italics the observations or comments of the auditor which have any adverse effect on the functioning of the company. The auditor should also consider whether any observations or comments made by the auditor in his report under the Order contain such matters, which, in his opinion, might have any adverse effect on the functioning of the company. If so, the auditor should give his comment in thick type or italics as required by the said section. An example in this regard may be where accumulated losses of the company at the end of the financial year are more than fifty per cent of its net worth and it has incurred cash losses in period covered by the audit report and in the immediately preceding financial year also.

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

95. A specimen form of report is given in **Appendix XIII**. It will be noticed that the comments under the Order are given in the form of an Annexure, as stated in paragraph 83 above. Where an "Annexure" form is not used, the comments will appear in the body of the report itself.

Board's Report

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

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

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

**Announcement regarding Statutory Auditor's Reporting
Responsibilities in Respect of Depositing of Cess
Pursuant to Clause 4(ix)(a) of the Companies (Auditor's
Report) Order, 2003 and Section 227(3)(g) of the
Companies Act, 1956**

1. The Council of the Institute, at its 312th meeting held on December 25 - 27, 2011, noted that paragraph 4(ix)(a) of the Companies (Auditor's Report) Order, 2003 required the statutory auditor to report on the matter relating to regularity of the company in depositing undisputed statutory dues as follows:

"Is the company regular in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Employees' State Insurance, Income -tax, Sales-tax, Wealth Tax, Service Tax, Custom Duty, Excise Duty, Cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.[Paragraph 4(ix)(a)]"

2. The Council also noted that paragraph 63(g) of the Statement on the Companies (Auditor's Report) Order, 2003, issued by the Institute of Chartered Accountants of India states as follows:

*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. (emphasis added)***

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3. The Council noted that till date the Central Government had not notified the effective date of section 441A of the Companies Act, 1956. Consequently, no Rules thereunder had also been prescribed by the Central Government. Accordingly, there was no question of reporting thereon under the Companies (Auditor's Report) Order, 2003. The Council, therefore, decided that in view of the aforementioned situation, the statutory auditor need not report in respect of cess payable under section 441A of the Companies Act, 1956 as envisaged under paragraph 63(g) of the Statement on the Companies (Auditor's Report) Order, 2003. The Council, therefore, decided to modify paragraph 63(g) of the said Statement as follows:

"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. However, till the time such Rules are prescribed, the auditor need not make any comment in respect of the Cess under section 441A of the Companies Act, 1956 in his report under paragraph 4(ix)(a) of CARO 2003.~~"

4. The Council, incidentally, also noted that section 227(3)(g) of the Companies Act, 1956 required the statutory auditor's report to state, "Whether the cess payable under section 441A has been paid and if not, the details of amount of cess not so paid." It was also noted that the operative date of even section 227(3)(g) had not yet been notified by the Central Government.
5. Accordingly, as a corollary to the Council's views on auditor's reporting responsibilities on cess under section 441A of the Companies Act, 1956, pursuant to clause 4(ix)(a) of CARO, 2003, the Council was of the view that the statutory auditor's report need not contain any comment on section 227(3)(g) of the Companies Act, 1956.

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

**Published in the Gazette Of India
Extraordinary Part II, Section 3 - Sub-Section (i)**

**Ministry of Finance
(Department of Company Affairs)**

New Delhi, the 12th June, 2003

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

1. Short Title, Application and Commencement

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

2. Definitions

In this Order, unless the context otherwise requires:

- (a) **"Act"** means the Companies Act, 1956 (1 of 1956);
- (b) **"chit fund company", "nidhi company" or "mutual benefit company"** means a company engaged in the business of managing, conducting or supervising as a foreman or agent of any transaction or arrangement by which it enters into an agreement with a number of subscribers that every one of them shall subscribe to a certain sum of instalments for a definite period and that each subscriber, in his turn, as determined by lot or by auction or by tender or in such other manner as may be provided for in the agreement, shall be entitled to a prize amount, and includes companies whose principal business is accepting fixed deposits from, and lending money to, members;
- (c) **"finance company"** means a company engaged in the business of financing, whether by making loans or advances or otherwise, of any industry, commerce or agriculture and includes any company engaged in the business of hire-purchase, lease financing and financing of housing;
- (d) **"investment company"** means a company engaged in the business of acquisition and holding of, or dealing in, shares, stocks, bonds, debentures, debenture stocks, including securities issued by the Central or any State Government or by any local authority, or in other marketable securities of a like nature;
- (e) **"manufacturing company"** means a company engaged in any manufacturing process as defined in the Factories Act, 1948 (63 of 1948);
- (f) **"mining company"** means a company owning a mine, and includes a company which carries on the business of a mine either as a lessee or as occupier thereof;
- (g) **"processing company"** means a company engaged in the business of processing materials with a view to their use, a sale, delivery or disposal;
- (h) **"service company"** means a company engaged in the business of supplying, providing, maintaining and operating any services, facilities, conveniences, bureaux and the like for the benefit of others;
- (i) **"trading company"** means a company engaged in the business of buying and selling goods.

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

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

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

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

- (i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;
- (b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
- (c) if a substantial part of fixed assets have been disposed off during the year, whether it has affected the going concern;
- (ii) (a) whether physical verification of inventory has been conducted at reasonable intervals by the management;
- (b) are the procedures of physical verification of inventory followed by the management reasonable and adequate in relation to the size of the company and the nature of its business. If not, the inadequacies in such procedures should be reported;
- (c) whether the company is maintaining proper records of inventory and whether any material discrepancies were noticed on physical verification and if so, whether the same have been properly dealt with in the books of account;
- (iii) (a) has the company either granted or taken any loans, secured or unsecured to/from companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and amount involved in the transactions.
- (b) whether the rate of interest and other terms and conditions of loans given or taken by the company, secured or unsecured, are *prima facie* prejudicial to the interest of the company;
- (c) whether payment of the principal amount and interest are also regular;

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- (d) if overdue amount is more than one lakh, whether reasonable steps have been taken by the company for recovery/payment of the principal and interest;
- (iv) is there an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets and for the sale of goods. Whether there is a continuing failure to correct major weaknesses in internal control;
- (v)
 - (a) whether transactions that need to be entered into a register in pursuance of section 301 of the Act have been so entered;
 - (b) whether each of these transactions have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time;

(This information is required only in case of transactions exceeding the value of five lakh rupees in respect of any party and in any one financial year).

- (vi) in case the company has accepted deposits from the public, whether the directives issued by the Reserve Bank of India and the provisions of sections 58A and 58AA of the Act and the rules framed there under, where applicable, have been complied with. If not, the nature of contraventions should be stated; If an order has been passed by Company Law Board whether the same has been complied with or not?
- (vii) in the case of listed companies and/or other companies having a paid-up capital and reserves exceeding Rs.50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crore rupees for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business;
- (viii) where maintenance of cost records has been prescribed by the Central Government under clause (d) of sub-section (1) of section 209 of the Act, whether such accounts and records have been made and maintained;
- (ix)
 - (a) is the company regular in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Employees' State Insurance, Income-tax, Sales-tax, Wealth Tax, Custom Duty, Excise Duty, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year

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concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.

- (b) in case dues of sales tax/income tax/custom tax/wealth tax/excise duty/cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending may please be mentioned.

(A mere representation to the Department shall not constitute the dispute).

- (x) whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than fifty per cent of its net worth and whether it has incurred cash losses in such financial year and in the financial year immediately preceding such financial year also;
- (xi) whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported;
- (xii) whether adequate documents and records are maintained in cases where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities; If not, the deficiencies to be pointed out.
- (xiii) whether the provisions of any special statute applicable to chit fund have been duly complied with? In respect of nidhi/ mutual benefit fund/societies;
 - (a) whether the net-owned funds to deposit liability ratio is more than 1:20 as on the date of balance sheet;
 - (b) whether the company has complied with the prudential norms on income recognition and provisioning against sub-standard/ default/ loss assets;
 - (c) whether the company has adequate procedures for appraisal of credit proposals/requests, assessment of credit needs and repayment capacity of the borrowers;
 - (d) whether the repayment schedule of various loans granted by the nidhi is based on the repayment capacity of the borrower and would be conducive to recovery of the loan amount;
- (xiv) if the company is dealing or trading in shares, securities, debentures and other investments, whether proper records have been maintained of the

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transactions and contracts and whether timely entries have been made therein; also whether the shares, securities, debentures and other securities have been held by the company, in its own name except to the extent of the exemption, if any, granted under section 49 of the Act;

- (xv) whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and conditions whereof are prejudicial to the interest of the company;
- (xvi) whether term loans were applied for the purpose for which the loans were obtained;
- (xvii) whether the funds raised on short-term basis have been used for long term investment and vice versa; If yes, the nature and amount is to be indicated;
- (xviii) whether the company has made any preferential allotment of shares to parties and companies covered in the Register maintained under section 301 of the Act and if so whether the price at which shares have been issued is prejudicial to the interest of the company;
- (xix) whether securities have been created in respect of debentures issued?
- (xx) whether the management has disclosed on the end use of money raised by public issues and the same has been verified;
- (xxi) whether any fraud on or by the company has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

5. Reasons to be Stated for Unfavourable or Qualified Answers

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

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

RAJIV MEHRISHI
Joint Secretary

**Published in the Gazette of India
Extraordinary Part II, Section 3 – Sub-section (I)**

**Government of India
Ministry of Company Affairs
Notification**

New Delhi, the 25th November, 2004

G.S.R. 766(E): In exercise of the powers conferred by sub-section (4A) of section 227 of the Companies Act, 1956 (1 of 1956) and after consultation with the Institute of Chartered Accountants of India [constituted under the Chartered Accountants Act, 1949 (38 of 1949)], the Central Government hereby makes the following amendments in Companies (Auditor's Report) Order, 2003, namely:-

1. (1) This Order may be called the Companies (Auditor's Report) (Amendment) Order, 2004.
(2) It shall come into force on the date of its publication in the Official Gazette.
2. In the Companies (Auditor's Report) Order, 2003, -
 - (1) In paragraph 1, in sub-paragraph (2), for clause (iv), the following clause shall be substituted, namely:
“(iv) a private limited company with a paid up capital and reserves not more than rupees fifty lakh and which does not have loan outstanding exceeding rupees twenty five lakh from any bank or financial institution and does not have a turnover exceeding rupees five crore at any point of time during the financial year”.
 - (2) in paragraph 2, the clauses (c) to (i) shall be omitted;
 - (3) in paragraph 4,
 - (a) for clause (iii), the following clause shall be substituted, namely:
“(iii) (a) has the company granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and amount involved in the transactions; and

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- (b) whether the rate of interest and other terms and conditions of loans given by the company, secured or unsecured, are prima facie prejudicial to the interest of the company; and
 - (c) whether receipt of the principal amount and interest are also regular; and
 - (d) 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;
 - (e) has the company taken any loans, secured or unsecured from companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and the amount involved in the transactions; and
 - (f) whether the rate of interest and other terms and conditions of loans taken by the company, secured or unsecured, are prima facie prejudicial to the interest of the company; and
 - (g) whether payment of the principal amount and interest are also regular.”
- (b) for clause (iv), the following clause shall be substituted, namely:
- “(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;”
- (c) in clause (v), for sub-clauses (a) and (b), the following clauses shall be substituted, namely:-
- “(a) whether the particulars of contracts or arrangements referred to in section 301 of

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- the Act have been entered in the register required to be maintained under that section; and
- (b) whether transactions made in pursuance of such contracts or arrangements have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time;";
 - (d) in clause(vi),
 - (i) for the words, figures and letters "sections 58A and 58AA of the Act ", the words, figures and letters "sections 58A, 58AA or any other relevant provisions of the Act" shall be substituted.
 - (ii) for the words "Company Law Board", the words "Company Law Board or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal" shall be substituted;
 - (e) in clause (ix)
 - (i) in sub-clause (a), for the words "Wealth tax", the words "Wealth tax, Service tax" shall be substituted;
 - (ii) for sub-clause (b), the following sub-clause shall be substituted; namely:-

"(b) in case dues of Income tax/ Sales tax /Wealth tax/ Service tax/ Custom duty/ Excise duty/cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned."
 - (f) in clause (x), for the words "in the financial year immediately preceding such financial year also" the words "in the immediately preceding financial year" shall be substituted;
 - (g) in clause (xiii);

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- (i) in sub-clause (b), for the word "default" the word "doubtful" shall be substituted;
- (ii) in sub-clause (d), the words "and would be conducive to recovery of the loan amount" shall be omitted;
- (h) in clause (xiv), for the words "other securities", the words "other investments" shall be substituted;
- (i) in clause (xvii), the words "and vice-versa" shall be omitted.
- (j) in clause (xix), for the words "securities have", the words "security or charge has" shall be substituted.

File No: 2/28/2002-CL-V

Jitesh Khosla
Joint Secretary

Note: The Principal Order was issued vide notification number GSR 480(E) dated the 12th June, 2003.

**Final Reporting Requirements
Under Companies (Auditor's Report) Order, 2003**

*{after incorporating the amendments made by the Companies (Auditor's Report)
(Amendment) Order, 2004¹⁷ dated 25th November, 2004}*

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

- (i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;
- (b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
- (c) if a substantial part of fixed assets have been disposed off during the year, whether it has affected the going concern;
- (ii) (a) whether physical verification of inventory has been conducted at reasonable intervals by the management;
- (b) are the procedures of physical verification of inventory followed by the management reasonable and adequate in relation to the size of the company and the nature of its business. If not, the inadequacies in such procedures should be reported;
- (c) whether the company is maintaining proper records of inventory and whether any material discrepancies were noticed on physical verification and if so, whether the same have been properly dealt with in the books of account;
- (iii) (a) has the company granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and amount involved in the transactions; and
- (b) whether the rate of interest and other terms and conditions of loans given by the company, secured or unsecured, are prima facie prejudicial to the interest of the company; and

¹⁷ DCA Notification No. GSR 766(E).

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- (c) whether receipt of the principal amount and interest are also regular; and
 - (d) 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;
 - (e) has the company taken any loans, secured or unsecured from companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and the amount involved in the transactions; and
 - (f) whether the rate of interest and other terms and conditions of loans taken by the company, secured or unsecured, are prima facie prejudicial to the interest of the company; and
 - (g) whether payment of the principal amount and interest are also regular.
- (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.
- (v) (a) whether the particulars of contracts or arrangements referred to in section 301 of the Act have been entered in the register required to be maintained under that section; and
- (b) whether transactions made in pursuance of such contracts or arrangements have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time;
- (This information is required only in case of transactions exceeding the value of five lakh rupees in respect of any party and in any one financial year).
- (vi) in case the company has accepted deposits from the public, whether the directives issued by the Reserve Bank of India and the provisions of sections 58A, 58AA or any other relevant provisions of the Act and the rules framed there under, where applicable, have been complied with. If not, the nature of contraventions should be stated; If an order has been passed by Company Law Board 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?

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- (vii) in the case of listed companies and/or other companies having a paid-up capital and reserves exceeding Rs.50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crore rupees for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business;
- (viii) where maintenance of cost records has been prescribed by the Central Government under clause (d) of sub-section (1) of section 209 of the Act, whether such accounts and records have been made and maintained;
- (ix)
 - (a) is the company regular in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Employees' State Insurance, Income-tax, Sales-tax, Wealth Tax, Service Tax, Custom Duty, Excise Duty, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.
 - (b) in case dues of Income tax/ Sales tax /Wealth tax/ Service tax/ Custom duty/ Excise duty/ cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned.

(A mere representation to the Department shall not constitute a dispute).
- (x) whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than fifty per cent of its net worth and whether it has incurred cash losses in such financial year and in the immediately preceding financial year;
- (xi) whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported;
- (xii) whether adequate documents and records are maintained in cases where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities; If not, the deficiencies to be pointed out.

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- (xiii) whether the provisions of any special statute applicable to chit fund have been duly complied with? In respect of nidhi/ mutual benefit fund/societies;
 - (a) whether the net-owned funds to deposit liability ratio is more than 1:20 as on the date of balance sheet;
 - (b) whether the company has complied with the prudential norms on income recognition and provisioning against sub-standard/doubtful/loss assets;
 - (c) whether the company has adequate procedures for appraisal of credit proposals/requests, assessment of credit needs and repayment capacity of the borrower;
 - (d) whether the repayment schedule of various loans granted by the nidhi is based on the repayment capacity of the borrower;
- (xiv) if the company is dealing or trading in shares, securities, debentures and other investments, whether proper records have been maintained of the transactions and contracts and whether timely entries have been made therein; also whether the shares, securities, debentures and other investments have been held by the company, in its own name except to the extent of the exemption, if any, granted under section 49 of the Act;
- (xv) whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and conditions whereof are prejudicial to the interest of the company;
- (xvi) whether term loans were applied for the purpose for which the loans were obtained;
- (xvii) whether the funds raised on short-term basis have been used for long term investment; If yes, the nature and amount is to be indicated;
- (xviii) whether the company has made any preferential allotment of shares to parties and companies covered in the Register maintained under section 301 of the Act and if so whether the price at which shares have been issued is prejudicial to the interest of the company;
- (xix) whether security or charge has been created in respect of debentures issued;
- (xx) whether the management has disclosed on the end use of money raised by public issues and the same has been verified;
- (xxi) whether any fraud on or by the company has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

Appendix IV

**Amendments Made by the
Companies (Auditor's Report) (Amendment) Order, 2004
in the Companies (Auditor's Report) Order, 2003**

1. The Central Government of India, in exercise of the powers conferred by sub-section (4A) of section 227 of the Companies Act, 1956 (1 of 1956) and after consultation with the Institute of Chartered Accountants of India [constituted under the Chartered Accountants Act, 1949 (38 of 1949)], has issued circular no G.S.R. 766(E) the Companies (Auditor's Report) (Amendment) Order, 2004 making certain changes the Companies (Auditor's Report) Order, 2003. The Order has come into force on 25th November 2004.

2. The following table highlights the changes brought in by the Companies (Auditor's Report) (Amendment) Order, 2004.

(Text shown in strikethrough format in left hand side table is omitted by the Amendment Order, 2004. The text substituted by the Amendment Order is shown against that clause in right hand side of the table.)

CARO, 2003

Amendment Order, 2004

1. Short Title, Application and Commencement

- (1) This Order may be called the Companies (Auditor's Report) Order, 2003.
- (2) It shall apply to every company including a foreign company as defined under section 591 of the Act, except the following:
 - (i) a Banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
 - (ii) an insurance company as defined in clause (21) of section 2 of the Act;

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- (iii) a company licensed to operate under section 25 of the Act; and
- (iv) a private limited company with a paid up capital and reserves not more than fifty lakh rupees and has not accepted any public deposit and does not have loan outstanding ten lakh rupees or more from any bank or financial institution and does not have a turnover exceeding five crore rupees.

SUBSTITUTED BY:

(iv) a private limited company with a paid up capital and reserves not more than rupees fifty lakh and which does not have loan outstanding exceeding rupees twenty five lakh from any bank or financial institution and does not have a turnover exceeding rupees five crore at any point of time during the financial year.

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

2. Definitions

In this Order, unless the context otherwise requires-

- (a) "Act" means the Companies Act, 1956 (1 of 1956);
- (b) "chit fund company", "nidhi company" or "mutual benefit company" means a company engaged in the business of managing, conducting or supervising as a foreman or agent of any transaction or arrangement by which it enters into an agreement with a number of subscribers that every one of them shall subscribe to a certain sum of instalments for a definite period and that each subscriber, in his

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turn, as determined by lot or by auction or by tender or in such other manner as may be provided for in the agreement, shall be entitled to a prize amount, and includes companies whose principal business is accepting fixed deposits from, and lending money to, members;

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

CLAUSES (c) TO (i) OF
PARAGRAPH 2 OMITTED

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

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

~~(f) "mining company" means a company owning a mine, and includes a company which~~

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~~carries on the business of a mine either as a lessee or occupier thereof;~~

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

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

~~"trading company" means a company engaged in the business of buying and selling goods.~~

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

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

4. Matters to be included in the auditor's report.

The auditor's report on the account of a company to which this Order applies shall include a statement on the

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following matters, namely:

- (i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;
- (b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;
- (c) if a substantial part of fixed assets have been disposed off during the year, whether it has affected the going concern;
- (ii) (a) whether physical verification of inventory has been conducted at reasonable intervals by the management;
- (b) are the procedures of physical verification of inventory followed by the management reasonable and adequate in relation to the size of the company and the nature of its

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business. If not, the inadequacies in such procedures should be reported;

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

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

~~(b) whether the rate of interest and other terms and conditions of loans given or taken by the company, secured or unsecured, are prima facie prejudicial to the interest of the company;~~

~~(c) whether payment of the principal amount and interest are also regular;~~

~~(d) if overdue amount is more than one lakh, whether reasonable steps have been taken by the company for recovery/payment of the principal and interest;~~

SUBSTITUTED BY:

iii) (a) has the company granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and amount involved in the transactions; and

(b) whether the rate of interest and other terms and conditions of loans given by the company, secured or unsecured, are prima facie prejudicial to the interest of the company; and

(c) whether receipt of the principal amount and interest are also regular; and

(d) 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;
- (e) has the company taken any loans, secured or unsecured from companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and the amount involved in the transactions; and
- (f) whether the rate of interest and other terms and conditions of loans taken by the company, secured or unsecured, are prima facie prejudicial to the interest of the company; and
- (g) whether payment of the principal amount and interest are also regular.
- ~~(iv) is there an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets and for the sale of goods. Whether there is a continuing failure to correct major weaknesses in internal control;~~
- ~~(v)(a) whether transactions that need to be entered into a register in pursuance of section 301 of the Act have been so entered;~~
- ~~(b) whether each of these transactions have been made at prices which are reasonable having regard to the prevailing~~

SUBSTITUTED BY:

- (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;

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~~market prices at the relevant time;~~

(This information is required only in case of transactions exceeding the value of five lakh rupees in respect of any party and in any one financial year).

(vi) in case the company has accepted deposits from the public, whether the directives issued by the Reserve Bank of India and the provisions of sections ~~58A and 58AA of the Act~~ and the rules framed there under, where applicable, have been complied with. If not, the nature of contraventions should be stated; If an order has been passed by ~~Company Law Board~~ whether the same has been complied with or not?

(vii) in the case of listed companies and/or other companies having a paid-up capital and reserves exceeding Rs.50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crore rupees for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business;

SUBSTITUTED BY:

(v) (a) whether the particulars of contracts or arrangements referred to in section 301 of the Act have been entered in the register required to be maintained under that section; and

(b) whether transactions made in pursuance of such contracts or arrangements have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time;

SUBSTITUTED BY:

(vi) 58A, 58AA or any other relevant provisions of the Act

Company Law Board or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal

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

(ix)(a) is the company regular in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Employees' State Insurance, Income-tax, Sales-tax, ~~Wealth Tax~~, Custom Duty, Excise Duty, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.

SUBSTITUTED BY :

Wealth Tax, Service Tax

~~(b) in case dues of sales tax/income tax/custom tax/wealth tax/excise duty/cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending may please be mentioned.~~

SUBSTITUTED BY:

(b) in case dues of Income tax/ Sales tax /Wealth tax/ Service tax/ Custom duty/ Excise duty/ cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned.

(A mere representation to the Department shall not constitute the dispute).

(x) whether in case of a company which has been registered for a

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period not less than five years, its accumulated losses at the end of the financial year are not less than fifty per cent of its net worth and whether it has incurred cash losses in such financial year and in the financial year immediately preceding such financial year also;

SUBSTITUTED BY:

(x) In the immediately preceding financial year

- (xi) whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported;
- (xii) whether adequate documents and records are maintained in cases where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities; If not, the deficiencies to be pointed out.
- (xiii) whether the provisions of any special statute applicable to chit fund have been duly complied with? In respect of nidhi/mutual benefit fund/societies;
 - (a) whether the net-owned funds to deposit liability ratio is more than 1:20 as on the date of balance sheet;
 - (b) whether the company has complied with the prudential norms on income recognition and

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provisioning against
sub-
standard/default/loss
assets;

SUBSTITUTED BY:

doubtful

(c) whether the company
has adequate
procedures for appraisal
of credit
proposals/requests,
assessment of credit
needs and repayment
capacity of the
borrowers;

(d) whether the repayment
schedule of various
loans granted by the
nidhi is based on the
repayment capacity of
the borrower and would
~~be conducive to~~
~~recovery of the loan~~
~~amount;~~

(xiv) if the company is dealing or
trading in shares, securities,
debentures and other
investments, whether proper
records have been maintained
of the transactions and
contracts and whether timely
entries have been made
therein; also whether the
shares, securities, debentures
and ~~other securities~~ have been
held by the company, in its own
name except to the extent of
the exemption, if any, granted
under section 49 of the Act;

SUBSTITUTED BY:

Other Investments

(xv) whether the company has given
any guarantee for loans taken

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

- (xvi) whether term loans were applied for the purpose for which the loans were obtained;
- (xvii) whether the funds raised on short-term basis have been used for long term investment ~~and vice versa~~; If yes, the nature and amount is to be indicated;
- (xviii) whether the company has made any preferential allotment of shares to parties and companies covered in the Register maintained under section 301 of the Act and if so whether the price at which shares have been issued is prejudicial to the interest of the company;
- (xix) whether ~~securities have been~~ **SUBSTITUTED BY:**
created in respect of security or charge has
debentures issued?
- (xx) whether the management has disclosed on the end use of money raised by public issues and the same has been verified;
- (xxi) whether any fraud on or by the company has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

5. Reasons to be stated for unfavourable or qualified answers.

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

CARO, 2003 vis a vis MAOCARO, 1988
A Comparative Analysis

The following is a, clause by clause, comparison of the requirements of the Companies (Auditor's Report) Order, 2003 **(as amended by the CARO (Amendment) Order, 2004)** and the corresponding requirements of MAOCARO, 1988.

The major additions/modifications in the Companies (Auditor's Report) Order, 2003 as compared to MAOCARO, 1988 are shown in **bold** letters. Those clauses of the CARO which are substantially different from the corresponding clauses of the 1988 Order are also shown in bold letters. It may be noted that mere verbal or grammatical changes have not been highlighted.

CARO, 2003	MAOCARO, 1988
1. Short Title, Application and Commencement (1) This Order may be called the Companies (Auditor's Report) Order, 2003.	1. Short Title, Application and Commencement (1) This Order may be called the Manufacturing and Other Companies (Auditor's Report) Order, 1988.
2. It shall apply to every company including a foreign company as defined in section 591 of the Act, except the following:	2. (a) It shall apply to every company including a foreign company as defined in section 591 of the Companies Act, 1956 (1 of 1956) which is engaged or proposes to engage in one or more of the following activities, namely: (i) manufacturing, mining or processing; (ii) supplying and rendering services;

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	<p>(iii) trading; and</p> <p>(iv) the business of financing, investment, chit fund, <i>nidhi</i> or mutual benefit societies.</p> <p>(b) It shall not apply to:</p>
(i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);	(i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
(ii) an insurance company as defined in clause (21) of section 2 of the Act;	(ii) an insurance company as defined in section 2(21) of the Companies Act, 1956 (1 of 1956); and
(iii) a company licensed to operate under section 25 of the Act; and	(iii) a company licensed to operate under section 25 of the Companies Act, 1956 (1 of 1956).
(iv) a private limited company with a paid up capital and reserves not more than rupees fifty lakh and which does not have loan outstanding exceeding rupees twenty five lakh from any bank or financial institution and does not have a turnover exceeding rupees five crore at any point of time during the financial year.	

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(3) It shall come into force on the 1st day of July, 2003 ^{**} .	(3) It shall come into force on the 1st day of November, 1988.
2. Definitions In this Order, unless the context otherwise requires, (a) "Act" means the Companies Act, 1956 (1 of 1956);	2. Definitions In this Order:
(b) "chit fund company", "nidhi company" or "mutual benefit company" means a company engaged in the business of managing, conducting or supervising as a foreman or agent of any transaction or arrangement by which it enters into an agreement with a number of subscribers that every one of them shall subscribe to a certain sum of instalments for a definite period and that each subscriber, in his turn, as determined by lot or by auction or by tender or in such other manner as may be provided for in the agreement, shall be entitled to a prize amount, and includes companies whose principal business is accepting fixed deposits from, and lending money to, members;	(a) "Chit fund", "nidhi" or "mutual benefit" company means a company engaged in the business of managing, conducting or supervising as a foreman or agent of any transaction or arrangement by which it enters into an agreement with a number of subscribers that every one of them shall subscribe a certain sum of instalments for a definite period and that each subscriber, in his turn, as determined by lot or by auction or by tender or in such other manner as may be provided for in the agreement, shall be entitled to a prize amount, and includes companies whose principal business is accepting fixed deposits from, and lending money to, members;
<i>Omitted</i>	(b) "finance company" means a company engaged in the business of financing, whether

^{**} Readers may note that this column of the comparative table also incorporates the amendments to CARO, 2003 brought in by the Companies (Auditor's Report) (Amendment) Order, 2004. The Amendment Order is effective from 25th November, 2004.

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	by making loans or advances or otherwise, of any industry, commerce or agriculture and includes any company engaged in the business of hire-purchase, lease financing and financing of housing;
<i>Omitted</i>	(c) "investment company" means a company engaged in the business of acquisition and holding of, or dealing in, shares, stocks, bonds, debentures, debenture stocks, including securities issued by the Central or any State Government or by any local authority, or in other marketable securities of a like nature;
<i>Omitted</i>	(d) "manufacturing company" means a company engaged in any manufacturing process as defined in the Factories Act, 1948 (63 of 1948);
<i>Omitted</i>	(e) "mining company" means a company owning a mine, and includes a company which carries on the business of a mine either as a lessee or occupier thereof;
<i>Omitted</i>	(f) "processing company" means a company engaged in the business of processing materials with a view of their use, sale, delivery or disposal;
<i>Omitted</i>	(g) "service company" means a company engaged in the business of supplying,

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	providing, maintaining and operating any services, facilities, conveniences, bureaux and the like for the benefit of others;
<i>Omitted</i>	(h) "trading company" means a company engaged in the business of buying and selling goods.
3. Auditor's Report to Contain Matters Specified in Paragraphs 4 and 5 Every report made by the auditor under section 227 of Act, on the accounts of every company examined by him to which this Order applies for every financial year ending on any day on or after the commencement of this Order, shall contain the matters specified in paragraphs 4 and 5.	3. Auditor's Report to Contain Matters Specified in Paragraphs 4 and 5 Every report made by the auditor under section 227 of the Companies Act, 1956 (1 of 1956) on the accounts of every company examined by him to which this Order applies for every financial year ending on any day on or after the commencement of this Order, shall contain the matters specified in paragraphs 4 and 5.
4. Matters to be Included in the Auditor's Report The auditor's report on the account of a company to which this Order applies shall include a statement on the following matters, namely:	4. The Matters to be Included in the Auditor's Report The Auditor's Report on the accounts of a company to which this Order applies shall include a statement on the following matter, namely:
	(A) In the case of a manufacturing, mining or processing company:
(i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;	(i) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets; whether these fixed assets have been physically verified by the management at

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<p>(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;</p>	<p>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;</p> <p>(ii) whether any of the fixed assets have been revalued during the year, if so, the basis of revaluation should be indicated;</p>
<p>(c) if a substantial part of fixed assets have been disposed off during the year, whether it has affected the going concern;</p>	
<p>(ii) (a) whether physical verification of inventory has been conducted at reasonable intervals by the management;</p>	<p>(iii) whether physical verification has been conducted by the management at reasonable intervals in respect of finished goods, stores, spare parts and raw materials;</p>
<p>(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;</p>	<p>(iv) are the procedures of physical verification of stocks followed by the management reasonable and adequate in relation to the size of the company and the nature of its business? If not, the inadequacies in such procedures should be reported;</p>
<p>(c) whether the company is maintaining proper records of inventory</p>	<p>(v) whether any material discrepancies have been noticed on physical verification</p>

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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;	of stocks as compared to book records, and if so, whether the same have been properly dealt with in the books of account?
	(vi) whether the auditor, on the basis of his examination of stocks, is satisfied that such valuation is fair and proper in accordance with the normally accepted accounting principles? Is the basis of valuation of stocks same as in the preceding year? If there is any deviation in the basis of valuation, the effect of such deviation, if material, should be reported;
<p>{please see sub clauses (f) and (g) of paragraph 4(iii)}</p> <p>(iii) (a) has the company granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and amount involved in the transactions; and</p> <p>(b) whether the rate of interest and other terms and conditions of loans given by the</p>	<p>(vii) if the company has taken any loans, secured or unsecured, from companies, firms or other parties listed in the register maintained under section 301 of the Companies Act, 1956 (1 of 1956), and/or from the companies under the same management as defined under sub-section (1B) of section 370 of the Companies Act, 1956 (1 of 1956), whether the rate of interest and other terms and conditions of such loans are prima facie prejudicial to the interest of the company;</p> <p>(viii) if the company has granted any loans, secured or</p>

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<p>company, secured or unsecured, are prima facie prejudicial to the interest of the company; and</p> <p>(c) whether receipt of the principal amount and interest are also regular; and</p> <p>(d) 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;</p> <p>(e) has the company taken any loans, secured or unsecured from companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and the amount involved in the transactions; and</p>	<p>unsecured, to companies, firms or other parties listed in the register(s) maintained under section 301 and/or to the companies under the same management as defined under sub-section (1B) of section 370 of the Companies Act, 1956 (1 of 1956), whether the rate of interest and other terms and conditions of such loans are prima facie prejudicial to the interest of the company;</p>
<p>(f) whether the rate of interest and other terms and conditions of loans taken by the company, secured or unsecured, are prima facie prejudicial to the interest of the company; and</p> <p>(g) whether payment of the principal amount and interest are also regular.</p>	

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	(ix) whether the parties to whom the loans, or advances in the nature of loans, have been given by the company are repaying the principal amounts as stipulated and are also regular in payment of the interest and if not whether reasonable steps have been taken by the company for recovery of the principal and interest;
(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.	(x) is there an adequate internal control procedure commensurate with the size of the company and the nature of its business, for the purchase of stores, raw materials, including components, plant and machinery, equipment and other assets, and for the sale of goods;
(v) (a) whether the particulars of contracts or arrangements referred to in section 301 of the Act have been entered in the register required to be maintained under that section; and	
(b) whether transactions made in pursuance of such contracts or arrangements have been made at prices which are reasonable	(xi) whether the transactions of purchase of goods and materials and sale of goods, materials and services, made in pursuance of contracts or arrangements entered in the

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<p>having regard to the prevailing market prices at the relevant time;</p> <p>(This information is required only in case of transactions exceeding the value of five lakh rupees in respect of any party and in any one financial year).</p>	<p>register(s) maintained under section 301 of the Companies Act, 1956 (1 of 1956) as aggregating during the year to Rs.50,000/- (Rupees fifty thousand) or more in respect of each party, have been made at prices which are reasonable having regard to prevailing market prices for such goods, materials, or services or the prices at which transactions for similar goods or services have been made with other parties;</p> <p>(xii) whether any unserviceable or damaged stores, raw materials, or finished goods, are determined and whether provisions for the loss, if any, have been made in the accounts;</p>
<p>(vi) in case the company has accepted deposits from the public, whether the directives issued by the Reserve Bank of India and the provisions of sections 58A, 58AA or any other relevant provisions of the Act and the rules framed there under, where applicable, have been complied with. If not, the nature of contraventions should be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal</p>	<p>(xiii) in case the company has accepted deposits from the public, whether the directives issued by the Reserve Bank of India and the provisions of section 58A of the Companies Act, 1956 and the rules framed thereunder, where applicable, have been complied with. If not, the nature of contraventions should be stated;</p>

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whether the same has been complied with or not?	
	(xiv) is the company maintaining reasonable records for the sale and disposal of realisable by-products and scraps, where applicable;
(vii) in the case of listed companies and/or other companies having a paid-up capital and reserves exceeding Rs.50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crore rupees for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business;	(xv) in the case of companies having a paid-up capital exceeding Rs.25 lakh as at the commencement of the financial year concerned, or having an average annual turnover exceeding Rs.2 crores for a period of three consecutive financial years immediately preceding the financial year concerned; whether the company has an internal audit system commensurate with its size and nature of its business;
(viii) where maintenance of cost records has been prescribed by the Central Government under clause (d) of sub-section (1) of section 209 of the Act, whether such accounts and records have been made and maintained;	(xvi) where maintenance of cost records has been prescribed by the Central Government under section 209(1)(d) of the Companies Act, 1956 (1 of 1956), whether such accounts and records have been made and maintained;
(ix) (a) is the company regular in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund,	(xvii) is the company regular in depositing Provident Fund and Employees' State Insurance dues with the appropriate authority and if not, the extent of arrears of Provident Fund and Employees' State

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<p>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 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.</p>	<p>Insurance dues shall be indicated by the auditor;</p>
<p>(b) in case dues of Income tax/ Sales tax /Wealth tax/ Service tax/ Custom duty/ Excise duty/ cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned.</p> <p>(A mere representation to the Department shall not constitute the dispute)</p>	<p>(xviii) whether any undisputed amounts payable in respect of income tax, wealth tax, sales tax, customs duty and excise duty were outstanding, as at the last day of the financial year concerned, for a period of more than six months from the date they became payable; if so, the amounts of such outstanding dues should be reported;</p>
	<p>(xix) whether personal expenses have been charged to revenue</p>

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	account; if so, the details thereof should be reported;
	(xx) whether the company is a sick industrial company within the meaning of clause (o) of sub-section (1) of section 3 of the Sick Industrial Companies (Special Provisions) Act, 1985 (1 of 1986); if so, whether a reference has been made to the Board for Industrial and Financial Reconstruction under section 15 of the Act.
<p>(x) whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than fifty per cent of its net worth and whether it has incurred cash losses in such financial year and in the immediately preceding financial year;</p> <p>(xi) whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported;</p> <p>(xii) whether adequate documents and records are maintained in cases where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other</p>	

<p>securities; If not, the deficiencies to be pointed out.</p> <p>(xiii) whether the provisions of any special statute applicable to chit fund have been duly complied with? In respect of nidhi/ mutual benefit fund/societies;</p> <p>(a) whether the net-owned funds to deposit liability ratio is more than 1:20 as on the date of balance sheet;</p> <p>(b) whether the company has complied with the prudential norms on income recognition and provisioning against sub-standard/doubtful/loss assets;</p> <p>(c) whether the company has adequate procedures for appraisal of credit proposals/requests, assessment of credit needs and repayment capacity of the borrowers;</p> <p>(d) whether the repayment schedule of various loans granted by the nidhi is based on the repayment capacity of the borrower;</p> <p>(xiv) if the company is dealing or trading in shares, securities, debentures and other investments, whether proper records have been maintained of the transactions and contracts</p>	
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<p>and whether timely entries have been made therein; also whether the shares, securities, debentures and other investments have been held by the company, in its own name except to the extent of the exemption, if any, granted under section 49 of the Act;</p> <p>(xv) whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and conditions whereof are prejudicial to the interest of the company;</p> <p>(xvi) whether term loans were applied for the purpose for which the loans were obtained;</p> <p>(xvii) whether the funds raised on short-term basis have been used for long term investment; If yes, the nature and amount is to be indicated;</p> <p>(xviii) whether the company has made any preferential allotment of shares to parties and companies covered in the Register maintained under section 301 of the Act and if so whether the price at which shares have been issued is prejudicial to the interest of the company;</p>	
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<p>(xix) whether security or charge has been created in respect of debentures issued?</p> <p>(xx) whether the management has disclosed on the end use of money raised by public issues and the same has been verified;</p> <p>(xxi) whether any fraud on or by the company has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.</p>	
	<p>(B) In the case of a service company:</p> <p>(i) all the matters specified in clause (A) to the extent to which they are applicable;</p> <p>(ii) whether the company has a reasonable system of recording receipts, issues and consumption of material and stores and allocating materials consumed to the relative jobs, commensurate with its size and nature of its business;</p> <p>(iii) whether the company has a reasonable system of allocating man-hours utilised to the relative jobs, commensurate with its</p>

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	<p>size and nature of its business;</p> <p>(iv) whether there is a reasonable system of authorisation at proper levels, and an adequate system of internal control commensurate with the size of the company and the nature of its business, on issue of stores and allocation of stores and labour to jobs.</p> <p>(C) In the case of a trading company:</p> <p>(i) all the matters specified in clause (A) to the extent to which they are applicable;</p> <p>(ii) have the damaged goods been determined and if the value of such goods is significant, has provision been made for the loss.</p> <p>(D) In the case of a finance, investment, chit fund, nidhi or mutual benefit company:</p> <p>(i) all the matters specified in clause (A) to the extent to which they are applicable;</p> <p>(ii) whether adequate documents and records are maintained</p>
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	<p>in a case where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities;</p> <p>(iii) whether the provisions of any special statute applicable to chit fund, nidhi or mutual benefit society have been duly complied with; and</p> <p>(iv) if the company is dealing or trading in shares, securities, debentures and other investments, whether proper records have been maintained of the transactions and contracts and whether timely entries have been made therein; also whether the shares, securities, debentures and other investments, have been held by the company in its own name except to the extent of the exemption, if any, granted under section 49 of the Companies Act, 1956 (1 of 1956).</p>
5. Reasons to be Stated for Unfavourable or Qualified Answers.	5. Reasons to be Stated for Unfavourable or Qualified Answer

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<p>Where, in the auditor's report, the answer to any of the questions referred to in paragraph 4 is unfavourable or qualified, the auditor's report shall also state the reasons for such unfavourable or qualified answer, as the case may be. Where the auditor is unable to express any opinion in answer to a particular question, his report shall indicate such fact together with the reasons why it is not possible for him to give an answer to such question.</p>	<p>Where, in the Auditor's Report, the answer to any of the questions referred to in paragraph 4 is unfavourable or qualified, the Auditor's Report shall also state the reasons for such unfavourable or qualified answer, as the case may be. Where the auditor is unable to express any opinion in answer to a particular question, his report shall indicate such fact together with the reasons why it is not possible for him to give an answer to such question.</p>
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**List of Financial Institutions Covered Under
the Companies (Acceptance of Deposit) Rules, 1975**

1. Explanation to Rules 2(b)(xi) of the Rules state that “for the purpose of this sub-clause, the term 'financial institution' shall mean-

- (a) a public financial institution specified in or under section 4A of the Companies Act, 1956;
- (b) a State Financial, Industrial or Investment Corporation;
- (c) the State Bank of India or a subsidiary bank as defined in the State Bank of India (Subsidiary Banks) Act, 1959 (38 of 1959);
- (d) a nationalised bank, that is to say, a corresponding new bank as defined in section 2 of:-
 - (i) the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970 (5 of 1970); or
 - (ii) the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1980 (40 of 1980);
- (e) the General Insurance Corporation of India established in pursuance of the provisions of section 9 of the General Insurance Business (Nationalisation) Act, 1972 (57 of 1972);
- (f) the Industrial Reconstruction Corporation of India;¹⁸ or
- (g) any other Institution which the Central Government may, by notification, specify in this behalf;

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

- (i) the Industrial Credit and Investment Corporation of India Limited;
- (ii) the Industrial Finance Corporation of India;
- (iii) the Industrial Development Bank of India;
- (iv) the Life Insurance Corporation of India;
- (v) the Unit Trust of India;

¹⁸ Now Industrial Reconstruction Bank of India.

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(vi) the Infrastructure Development Finance Company Limited;

3. Sub-section (2) of section 4A of the Act, subject to the provisions of sub-section (1) empowers the Central Government to notify in the Official gazette such other institution as it may think fit to be a public financial institution. In exercise of the powers conferred by sub-section (2), the Central Government has notified the following 46 public financial institutions:

- (i) The Industrial Reconstruction Bank of India established under the Industrial Reconstruction Bank of India Act, 1984.
- (ii) The General Insurance Corporation of India, formed and registered under the General Insurance Business (Nationalisation) Act, 1984.
- (iii) The National Insurance Company Limited, formed and registered under the Companies Act, 1956.
- (iv) The New India Assurance Company Limited, formed and registered under the Companies Act, 1956.
- (v) The Oriental Fire and General Insurance Company Limited, formed and registered under the Companies Act, 1956.
- (vi) The United Fire and General Insurance Company Limited, formed and registered under the Companies Act, 1956.
- (vii) The Shipping Company and Investment Company of India Limited.
- (viii) Tourism Finance Corporation of India Limited, formed and registered under the Companies Act, 1956.
- (ix) IFCI Venture Capital Funds Limited formed and registered under the Companies Act, 1956.
- (x) Technology Development and Informations Company of India Limited, formed and registered under the Companies Act, 1956.
- (xi) Power Finance Corporation Limited, formed and registered under the Companies Act, 1956.
- (xii) National Housing Bank, established under the NHB Act, 1987.
- (xiii) Small Industries Development Bank of India Limited established under the Small Industries Development Bank of India Act, 1989.
- (xiv) Rural Electrification Corporation Limited formed and registered under the Companies Act, 1956.

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- (xv) Indian Railway Finance Corporation Limited, formed and registered under the Companies Act, 1956.
- (xvi) Industrial Finance Corporation of India Limited, formed and registered under the Companies Act, 1956.
- (xvii) Andhra Pradesh State Financial Corporation.
- (xviii) Assam Financial Corporation.
- (xix) Bihar State Financial Corporation.
- (xx) Delhi Financial Corporation.
- (xxi) Gujarat Financial Corporation.
- (xxii) Haryana Financial Corporation.
- (xxiii) Himachal Pradesh Financial Corporation.
- (xxiv) Jammu and Kashmir State Financial Corporation.
- (xxv) Karnataka State Financial Corporation.
- (xxvi) Kerala Financial Corporation.
- (xxvii) Madhya Pradesh Financial Corporation.
- (xxviii) Maharashtra State Financial Corporation.
- (xxix) Orissa State Financial Corporation.
- (xxx) Punjab Financial Corporation.
- (xxxi) Rajasthan Financial Corporation.
- (xxxii) Tamil Nadu Industrial Investment Corporation Limited.
- (xxxiii) Uttar Pradesh Financial Corporation.
- (xxxiv) West Bengal Financial Corporation.
- (xxxv) Indian Renewable Energy Development Agency Limited.
- (xxxvi) North Eastern Development Finance Corporation Limited.
- (xxxvii) Housing and Urban Development Corporation Limited.
- (xxxviii) Export and Import Bank of India.
- (xxxix) National Bank for Agriculture and Rural Development (NABARD).
- (xl) National Co-operative Department Corporation (NCDC).
- (xli) National Dairy Development Bank (NDDB)

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- (xlii) The Pradeshiya Industrial Development and Investment Corporation Limited.
- (xliii) Rajasthan State Industrial Development and Investment Corporation Limited.
- (xliv) The State Industrial and Investment Corporation of Maharashtra Limited.
- (xlv) West Bengal Industrial Development Corporation Limited.
- (xlvi) Tamil Nadu Industrial Development Corporation Limited.

Appendix VII

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

**Government of India
Ministry of Finance
(Department of Company Affairs)**

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

General Circular No:32/2003

Dated: 10th November, 2003

To

All Regional Directors
All Registrars of Companies

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

Sir,

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

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

3. However, keeping in view the difficulties of the companies as well as the professionals involved, it has also been decided that while companies to whom the Order is applicable, should make serious efforts to comply with the new

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Order from the effective date, cases of non compliance for accounts pertaining to financial year which closed on 31st December, 2003 or earlier, Government would take a lenient view provided the accounts at least carry MAOCARO Report, if required.

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

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

Yours faithfully,

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

Appendix VIII

This checklist does not form part of the Statement and is only illustrative in nature. Members are expected to exercise their professional judgment while making its use depending upon facts and circumstances of each case and read this check list in conjunction with the Statement on Companies (Auditor's Report) Order 2003.

**An Illustrative Checklist
on Companies (Auditor's Report) Order, 2003**

[As Amended by Companies (Auditor's Report) (Amendment) Order, 2004]

Client :

Audit Period :

Manager In-Charge:

Clause no.	Particulars	Remarks	Working Paper Reference
4(i)(a)	Whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets.		
(a)	Whether records of Fixed Assets (tangible, intangible and leased assets) are maintained showing the following particulars:		
	(i)	Sufficient description (distinctive numbers, purchase agreement, documents, records and registration references, etc.) of the asset to make identification possible.	
	(ii)	Classification, that is, the head under which it is shown in the accounts, e.g., plant	

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and machinery, office
equipment, etc.

- (iii) Location/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 and basis of
depreciation,
particulars regarding
amortisation and
impairment
- (x) Depreciation,
amortisation and
impairment for the
current year.
- (xi) Accumulated
depreciation,
amortisation and
impairment loss.
- (xii) Particulars regarding
sale, discarding,
demolition,
destruction etc.
- (xiii) Particulars of fixed

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assets that have
been retired from
active use and held
for disposal.

- (xiv) Particulars of fixed
assets that have
been fully
depreciated or
amortised or
impaired.

- (b) Whether aggregate
original cost, depreciation
or amortisation to date and
impairment loss, if any, as
per the register/records
agrees with General
Ledger balances? If not,
note the disagreements in
respect of each class of
assets.

Conclusion:

- 4(i)(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.**

- (a) (i) Whether Fixed
Assets were
physically verified
at any time during
the year or earlier
years according to
a phased program?
- (ii) What is the
periodicity of
physical verification
and whether the

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same is
reasonable?

- (iii) Whether assets
physically verified
agreed/ reconciled
with book figures?

If not, note the
discrepancies against
each class of assets in
terms of value, and state
how the discrepancies
have been dealt with.

- (iv) Instructions to
officials for carrying
out physical
verification to
include procedures,
timing, competency
of team members,
countsheets/tags,
formats etc.

- (b) Physically verify few
items from the fixed asset
register & vice versa.

- (c) Whether management
representation is
obtained confirming that:

- ◆ fixed assets are
physically verified by
the company in
accordance with the
policy of the
company.
- ◆ periodicity of the
physical verification
of fixed assets.

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- ◆ details of the material discrepancies noticed during the physical verification of the fixed assets.
- ◆ If no discrepancies were noted during physical verification, the same should be clearly mentioned.

Conclusion:

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

- (a) Whether the company has disposed off substantial part of fixed assets during the accounting period? If yes, whether the disposal of such part of the fixed assets has triggered the risk of going concern assumption being no longer appropriate? Is such risk mitigated by factors such as the management's plan to adopt a more profitable line of business, or where the sale of fixed assets is for generating funds for fresh acquisition of fixed assets?
- (b) Whether sufficient and appropriate audit

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evidence obtained
(General Meeting
minutes, Board minutes,
minutes of committees,
representation from
management etc.) that
plans of the management
are feasible, are likely to
be implemented, and that
the outcome of these
plans would improve the
situation.

- (c) Whether going concern
assumption is appropriate
due to mitigating factors?
- i. If yes, whether
plan or factors that
need to be
disclosed have
been disclosed?
- ii. If no, whether
adequate
disclosure has
been made in the
financial statement
and the fact been
highlighted in the
Report?

Conclusion:

- 4(ii)(a) **Whether physical verification of inventory has been conducted at
reasonable intervals by the management.**
- (a) Has the management
physically verified the
inventory, as defined in
AS 2? Inventory normally
includes-

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- ◆ Raw materials and Components
- ◆ Packing materials
- ◆ Maintenance supplies
- ◆ Work in progress
- ◆ Finished Goods
- ◆ Stores and Spares
- ◆ Consumables and Loose tools

(b) Whether evidence of physical verification has been seen and reasonableness of periodicity and procedure of physical verification evaluated? If yes, verify:

- ◆ written instructions issued by the management.
- ◆ duly authenticated physical verification sheets.
- ◆ duly authenticated summary sheets/ consolidation sheet
- ◆ internal memo etc. regarding issues arising on physical verification.
- ◆ any other documents evidencing physical verification.

Conclusion:

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- 4(ii)(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.**
- (a) Whether stock-taking procedures were reasonable and adequate in relation to the size of the Company, nature of its business and volume of stock? If not, list out the inadequacies / weaknesses so observed.
 - (b) Whether the management has instituted adequate cut-off procedures?
 - (c) Whether the original physical verification sheets have been reviewed and selected items traced into the final inventories? (including the more valuable ones as per ABC classification)
 - (d) Whether the comparison of final inventories with stock has been done? Whether records and other corroborative evidence, e.g. inventory statements submitted to banks?
 - (e) Whether the procedures for identifying damaged

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and obsolete items of
inventory operate
properly?

- (f) Instructions issued by
the management
- (g) In case of continuous
stock taking method,
whether management:
 - (i) maintains adequate
and up-to-date
stock records;
 - (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.

Conclusion:

- 4(ii)(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.**

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- (a) Proper records, in general, should contain, among other things, the following particulars:
- ◆ details regarding quantity of the receipts, issues, balances and dates of transactions in a chronological manner;
 - ◆ particulars of the item, like nomenclature, nature, etc.
 - ◆ relevant document no. & department identification, if any;
 - ◆ identification code of the item;
 - ◆ physically verified quantities;
 - ◆ location/situation;
 - ◆ valuation details; if any.
- (b) Whether the transactions entered in stock registers are duly supported by relevant documents.
- (c) Whether stock register is updated and value of inventory extracted from above said records tally with the books of account.

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- (d) If any material discrepancies were found as compared to stock records, what were the extent of discrepancies (in terms of value) and how the same have been dealt with in the books of account as well as in the stock records?

Conclusion:

- 4(iii)(a) **Has the company granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and amount involved in the transactions; and**

- (i) Has the Company granted any loans (Secured or Unsecured) to companies, firms or other parties listed in the register maintained under Section 301 of the Act? If yes, give number of parties and the maximum amount involved at any time during the year.
- (ii) Where the company has granted any loans to section 301 parties and squared off during the year, give

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details of such
transactions ?

Conclusion:

- 4(iii)(b) **Whether the rate of interest and other terms and conditions of loans given by the company, secured or unsecured, are prima facie prejudicial to the interest of the company; and**

Whether the terms of loans are prima facie prejudicial, due consideration to be given to the factors mentioned below:

- ◆ terms & condition of the loan repayment, rate of interest, restrictive covenants etc.,
- ◆ company's financial standing, its ability to lend,
- ◆ the nature of the security,
- ◆ prevailing market rate of interest etc.

Conclusion:

- 4(iii)(c) **Whether the receipt of principal amount and interest are also regular; and**

- (a) Whether principal amount and interest thereon are received regularly on the due date or immediately thereafter or annually in case due date is not specified?

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- (b) If not, the same should be reported.

Conclusion:

- 4(iii)(d) **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.**

- (a) Whether reasonable steps taken for recovery of loan?

- (b) Following documents may be seen for verification of reasonableness of steps taken by the company for recovery of principal and accrued interest on loan granted:

- ◆ Facts of each case including amounts involved
- ◆ Issue of reminder
- ◆ Sending of advocates or solicitor's notice

In absence of legal steps whether auditor is satisfied that reasonable steps have been taken

- (c) Obtain management's representation regarding steps that have been taken for recovery of overdue amounts exceeding rupees one lakh.

Conclusion:

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4(iii)(e) **Has the company taken any loans, secured or unsecured from companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and the amount involved in the transactions; and**

(i) Has the company taken any loans (secured or unsecured) from companies, firms or other parties listed in the register maintained under section 301 of the Act? If yes, give number of parties and the maximum amount involved at any time during the year.

(ii) Where the company has taken any loans from section 301 parties and squared off during the year, give details of such transactions?

Conclusion:

4(iii)(f) **Whether the rate of interest and other terms and conditions of loans taken by the company, secured or unsecured, are *prima facie* prejudicial to the interest of the company; and**

Whether the terms of loans are *prima facie* prejudicial, due consideration to be given to the factors mentioned below:

- ◆ Terms and conditions of the loan repayment, rate of interest, restrictive covenants, etc.

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- ◆ Company's financial standing, its ability to borrow.
- ◆ The nature of the security
- ◆ The availability of alternative sources of finance.
- ◆ The urgency of borrowing
- ◆ The purpose of the loan
- ◆ Prevailing market rate of interest, etc.

Conclusion:

4(iii)(g) **Whether payment of the principal amount and interest are also regular.**

- (a) Whether principal amount and interest thereon are paid regularly on the due date or immediately thereafter or annually in case due date is not specified?
- (b) If not, the same should be reported.

Conclusion:

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

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- (a) Complete the standard questionnaire in respect of:

- ◆ Inventory
- ◆ Fixed Assets
- ◆ Sales
- ◆ Services

(refer Appendix IX)

- (b) Prepare Summary statements for each section showing the major weakness in the system which calls for our reservations.

Note:

(Major weakness depends upon facts and circumstances.

Ordinarily, any weakness in the internal control that may result into a significant loss to the company or may result in a material misstatement is considered to be a major weakness.)

- (c) Whether continuing failure is with reference to the weakness that existed at the time of previous year's audit and known to the management and not corrected on the date of Balance Sheet?

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- (d) Whether there was a continuing failure to correct major weakness in the internal control system, is corrected at the time of issuance of report, state the fact.
- (e) Whether management has taken reasonable steps to correct major weakness in the internal control system, but weakness continues, if yes, report the weakness and steps taken for correcting the weakness.
- (f) Whether the report of internal auditors, minutes of the meeting of the audit committee if any, previous year's working paper have been reviewed in order to determine weaknesses in the internal controls already communicated to management?
- (g) Whether the existence of any major weakness in the internal control that has adverse effect have been considered for reporting appropriately?

Conclusion:

- 4(v)(a) **Whether the particulars of contracts or arrangements referred to in Section 301 of the Act have been entered in the register required to be maintained under that section; and**

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- (a) Whether a written representation from the management has been obtained concerning the completion of the entries in the register required to be maintained under section 301 of the Act?
- (b) Whether the completeness of the entries as stated above have been verified with reference of the following:
- ◆ review of working papers for the prior years;
 - ◆ review the entity's procedures for identification of parties;
 - ◆ review Form 24AA, and ensure compliance with provisions of section 297 & 299
 - ◆ Tracing transactions in the books of Account
- c) In case the company has not maintained the register required to be maintained by it under Section 301, mention the fact of non-maintenance/ improper maintenance of the aforesaid register.

Conclusion:

- 4(v)(b) **Whether transactions made in pursuance of such contracts or Arrangements have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time.**

(This information is required only in case of transactions exceeding the value of five lakh rupees in respect of any party and in any one financial year.)

- (a) Whether reasonableness of the prices of transactions, exceeding the value of Rs. 5,00,000/- in respect of any party and during the financial year, entered in pursuance of contracts or arrangements entered in the register(s) maintained u/s 301 of the Act, ensured on the basis of prevailing market prices at the relevant time and all the factors surrounding the transactions such as the delivery period/ schedule of implementation, the quality of the product/ service, the quantity, the credit terms, the previous record of supplier/ buyer/ client, Quotation analysis reasons for not taking lowest/highest prices etc.
- (b) In cases where transactions are entered with sole suppliers also ensure that the fact is stated in the report, examine the reasonableness of prices

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paid with reference to list
prices of the supplier
concerned, other trade
terms of the supplier, etc.

Conclusion:

- 4(vi) **In case the company has accepted deposits from the public, whether the directives issued by the Reserve Bank of India and the provisions of sections 58A , 58AA or any other relevant provisions of the Act and the rules framed there under, where applicable, have been complied with. If not, the nature of contraventions should be stated; if an order has been passed by Company Law Board 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?**
- (a) If the Company has accepted deposits from the public state whether:
- (i) The directives issued by the Reserve Bank of India have been complied with and also that:
 - (ii) The provisions of Section 58A or any other provisions of the Companies Act, and the rules framed there under have been complied with.
 - (iii) List out contraventions, if any.
- (b) Whether there is noncompliance of

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section 58AA, failure of the company to intimate the tribunal any default in repayment of deposit made by small investors or part thereof or any interest thereon.

- (c) Where an order has been passed by the CLB or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal in respect of above, examine the steps taken by the company to comply with the order, and if not, report briefly stating there in the nature of contravention and the fact that Company has not complied with the order.

Conclusion:

- 4(vii) **In the case of listed companies and/or other companies having a paid-up capital and reserves exceeding Rs.50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crores rupees for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business.**

Have you considered the following factors to determine whether the internal audit system is commensurate with the

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size of the company and
nature of its business:

- (a) Is there an internal audit system in the Company? (Mere internal check should not be considered as internal audit).
- (b) Has the internal audit been conducted by a separate internal audit department or by outside professional firm?
- (c) Is the internal audit department sufficient in size and properly manned to perform the internal audit function?
- (d) Is the head of the internal audit department a member of the Institute of Chartered Accountants of India?
- (e) Is it independent of the accounting and custody departments?
- (f) To whom the department is responsible?

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- (g) Are the audits conducted in accordance with the generally accepted auditing standards?
- (h) Do the Internal Auditors have questionnaires or guide manual?
- (i) Whether audit work is carried out according to a plan and programme and, if so what are the areas covered this year?
- (j) Whether adequate files and records are maintained by the Internal Auditors?
- (k) Do the Internal Auditors' Reports give:
 - ◆ Conclusions on the audit?
 - ◆ Exceptions to the Account and Records?
 - ◆ Recommendations on the internal control and procedures?
- (l) With respect to the Internal Auditors' Reports:

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- ◆ are they sent to an appropriate operating official?
- ◆ is corrective/remedial action initiated?
- ◆ do internal auditors follow up to see that appropriate action is taken?
- ◆ do the files indicate that appropriate action was taken?

Conclusion:

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

Whether cost accounting records have been prescribed for the company under section 209 (1)(d) of the Companies Act? If so verify whether proper cost accounts and records are made and maintained by the Company as prescribed.

Conclusion:

- 4(ix)(a) **Is the company regular in depositing undisputed statutory dues including provident fund, investor education and protection fund, employees' state insurance, income-tax, sales-tax, wealth tax, service tax, custom duty, excise duty, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last**

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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.

- (a) Whether a list of statutory dues which company is required to deposit regularly has been obtained.
- (b) In case 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 fact should be stated.
- (c) Whether the Company has been generally regular in depositing statutory dues or otherwise, indicate the same.

Note: A matter is 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.

- (d) Whether penalty and/or interest levied under the respective law is included under amounts payable.

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- (e) Ensure that disclosure is restricted to the actual arrears and should not include the amounts which have not fallen due for deposit and have been shown as arrears at the balance sheet date.
- (f) Whether the information about arrears of outstanding statutory dues is provided in the format:
 - ◆ Name of the Statute
 - ◆ Nature of the dues
 - ◆ Amount (Rs.)
 - ◆ Period to which amount relates
 - ◆ Due date
 - ◆ Date of Payment
- (g) Whether a written representation with reference to the date of the balance sheet from the management obtained:
 - ◆ specifying the cases and the amounts considered disputed;
 - ◆ containing a list of the cases and the amounts in respect of the statutory dues which are

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undisputed and
have remained
outstanding for a
period of more than
six months from the
date they became
payable;

- ◆ containing a
statement as to the
completeness of the
information provided
by the management.

- (h) Whether any register of
significant laws with
which the entity has to
comply within its
particular industry and a
record of complaints in
respect of non-
compliance been
maintained

Conclusion:

- 4(ix)(b) **In case dues of income tax/sales tax/ wealth tax/service tax/
custom duty/excise duty/cess have not been deposited on
account of any dispute, then the amounts involved and the forum
where dispute is pending shall be mentioned. (A mere
representation to the department shall not constitute a dispute.)**

- (a) Review internal audit
report, minutes of the
meeting of the board of
Directors and audit
committee
- (b) Ensure that information
about arrears of disputed
statutory dues is
provided in the format:

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- ◆ Name of the Statute
- ◆ Nature of the dues
- ◆ Amount (Rs.)
- ◆ Period to which amount relates
- ◆ Forum where dispute is pending

- 4(x) **Whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than fifty per cent of its net worth and whether it has incurred cash losses in such financial year and in the immediately preceding financial year .**
- (a) Whether the Company is in existence for more than five years
- (b) Whether the accumulated losses at the end of the financial year exceed 50% of the net worth or not?
- (c) Whether the company has incurred cash losses in current year?
- (d) Whether the company has incurred cash losses in the immediately preceding financial year?
- (e) Whether effect of qualification on the figure of accumulated losses, net worth and cash losses considered? In case qualification is not capable of being quantified, whether the

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fact is stated in the
Report?

Conclusion:

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

(a) Whether all defaults existing at the balance sheet date are reported irrespective of when those defaults have occurred.

(b) If application of reschedulement of loan has been made/accepted or default has been made good during the accounting period, whether the fact has been stated.

(c) Whether the disputes between the company and the lender on various issues give rise to disclaimer stating the fact there is a dispute between the company and the lender and auditor is unable to determine whether there is a default in repayment of dues to the lender concerned.

Conclusion:

4(xii) **Whether adequate documents and records are maintained in cases where the company has granted loans and advances on the**

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basis of security by way of pledge of shares, debentures and other securities; If not, the deficiencies to be pointed out.

(a) Has the company maintained the following documents & records:

- ◆ full name and address of the borrower.
- ◆ amount of the loan or advance.
- ◆ Stipulations regarding period of repayment, the rate of interest, the security to be pledged and all other terms of the loan or advance.
- ◆ The record of the disbursements, repayments towards the loan or advance and recovery of the interest.
- ◆ Full particulars of the security pledged.
- ◆ documents needed to transfer the ownership of the security in case of need.
- ◆ Periodical acknowledgements from the parties confirming the balances due.

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- ◆ Proof that the party has power to borrow, e.g., in case the borrower is a company, its memorandum of association, board resolution or shareholders' resolution.
Information about market value of securities such as stock exchange quotations.

- (b) Whether physical verification of security pledged carried on.
- (c) Whether security is in the custody of company and market value of security is adequate to cover the outstanding amount of loan and interest.
- (d) Whether there is any deficiency, observed at the time of examining various documents and record as referred above? if yes, report the same.

Conclusion:

4(xiii) **Whether the provisions of any special statute applicable to chit fund have been duly complied with?**

- (a) Enquire whether company is carrying

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on the chit fund business? (a transaction is not a chit within the meaning of this clause, if in such transaction:

- ◆ Some alone, but not all, of the subscribers get the prize amount without any liability to pay future subscriptions; or
- ◆ All the subscribers get the chit amount by turn with a liability to pay future subscriptions.)

- (b) Ensure that the company has complied with all the provisions of the special statutes, relating to of the chit fund company and state the same.

In respect of nidhi/mutual benefit fund/societies:

- (a) whether the net-owned funds to deposit liability ratio is more than 1:20 as on the date of balance sheet;
- (b) whether the company has complied with the prudential norms on income recognition and provisioning against sub-standard/ doubtful/loss assets;
- (c) whether the company has adequate procedures for appraisal of credit proposals/ requests, assessment of credit needs and repayment capacity of the borrowers;

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- (d) **Whether the repayment schedule of various loans granted by the nidhi is based on the repayment capacity of the borrower.**
- (a) Whether, in the case of a *nidhi* and mutual benefit society, net-owned funds to deposit liability ratio is more than 1:20 as on the date of balance sheet?
- (i) Net owned funds in the case of a *nidhi* or a mutual benefit society means the aggregate of paid-up equity capital and free reserves as reduced by accumulated losses and intangible assets appearing in the last audited balance sheet of the company.
- (ii) Free reserves is a reserve is considered as a “free reserve” if it is available for distribution as dividend.
- (iii) The amount representing the proceeds of issue of preference shares shall not be included for calculating net-owned funds. However, for *nidhis* or mutual benefit societies existing on

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or before 26th July 2001, the proceeds of issue of preference shares are to be included for calculation of net-owned funds up to the financial year 31st March 2003.

- (iv) Deposit liability would mean the aggregate deposits accepted by the company.
- (b) Ensure that ratio is computed by using the figures of net owned funds and deposit liability computed in accordance with as stated under this clause.
- (c) Sub Clause (b) of the Order requires, whether, the company has complied with the prudential norms on income recognition and provisioning against sub-standard/doubtful and loss assets.
- (d) Whether the prudential norm for revenue recognition and classification of assets has been complied with by the *nidhi* or mutual benefit society in the preparation and presentation of the financial statements? If not state the fact in report.

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- (e) Examine, as per sub-clause (c) of the order study and analyse the various procedures prevailing in the company for appraisal of credit proposals/requests, assessment of credit needs and repayment capacity of the borrowers and their follow up.
- (f) As per sub-clause (d) of the order whether the repayment schedule of various loans granted by the *nidhi* is based on the repayment capacity of the borrower. Scope is limited to the examination of documents available with the company in regard to loan.
- (g) Ensure that the system, policies and procedures are complied with based on the examination of all large loans and a test check of other loans.
- (h) Have we examined the documentation available with the company with regard to large loans.

Conclusion:

- 4(xiv) **If the company is dealing or trading in shares, securities, debentures and other investments, whether proper records have been maintained of the transactions and contracts and whether timely entries have been made therein; also whether the shares,**

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

Note: The clause is not applicable to a company which invest its surplus funds with a view to earn income from investment of surplus funds.

- (a) Whether:
- ◆ records regarding transactions and contracts are maintained;
 - ◆ timely entries have been made in such records; and
 - ◆ the investments are in the company's own name.
- (b) Whether the form in which records have been maintained is adequate, properly written up and preserved?
- (c) Whether adequacy of the records maintained can be verified from the following:
- ◆ purchases and sales and the profit or loss arising on sale,
 - ◆ the stock of investments and their valuation, and
 - ◆ the amounts due for sales and payable for purchases.

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(d) To ascertain that timely entries are made in the records, have you applied any of the following methods:

- ◆ a surprise inspection of the records;
- ◆ an examination of the system of internal control with particular reference to the manner in which and the time at which entries are made in the records; and
- ◆ an examination of the internal audit reports to ensure if the programme of internal audit specifically covers an inspection of the records to determine whether entries are made in time.

(e) In case investments which are intended to be sold immediately may not have been transferred in the name of the company, whether, in the circumstances of each case, the failure to transfer the investments to the company's name is understandable.

Conclusion:

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- 4(xv) **Whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and conditions whereof are prejudicial to the interest of the company.**
- (a) Whether the company has given any guarantee for loans taken by others from bank or financial institutions? If yes, examine the terms and conditions of guarantees given by the company for loans taken by other.
 - (b) Ensure on the basis of examination of Memorandum of Association whether company can issue guarantees?
 - (c) Obtained a list of guarantees issued by the company during the year from the management.
 - (d) Whether there are adequate internal controls over issuance of guarantees?
 - (e) Review the guarantees to ensure the reasonableness thereof in view of previous experience and knowledge of current year's activities.
 - (f) Whether the tangible/intangible benefits flowing to the company due to furnishing of guarantee are commensurate with risk undertaken by the company in doing so.

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- (g) Whether on the basis of examination carried out, the company could have provided the guarantee on better terms and conditions, obtain the company's explanation in writing as to why the company considers that the terms obtained are not prejudicial to the interest of the company.
- (h) In case the explanation given above is not convincing, state that the terms and conditions on which the company has given the guarantees are prejudicial to the interests of the company and also disclose the amount involved in such guarantee.
- (i) Whether compliance with the provisions with sections 295 and 372A of Companies Act ensured?
- (j) Whether a written representation from the management obtained that:
- ◆ all obligations in respect of guarantees have been duly recorded in the register and disclosed;
 - ◆ there are no guarantees issued up to the year-end which are yet to be recorded; and
 - ◆ disclosed contingent liabilities do not include

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any contingencies which
are likely to result in a
loss and which,
therefore, require
adjustment of assets or
liabilities.

Conclusion:

- 4(xvi) **Whether the term loans were applied for the purpose for which the loans were obtained.**
- (a) Whether the company has taken any term loan?
 - (b) Examine the terms and conditions subject to which the company has obtained the term loans including purpose for which term loans were sanctioned?
 - (c) Compare the purpose for which term loans were sanctioned with the actual utilisation of the loans and obtain sufficient appropriate audit evidence regarding the utilisation of the amounts raised.
 - (d) In case during a construction phase surplus funds were temporarily invested, however, subsequently the same are utilised for the stated objectives, mention the fact that the funds were temporarily used for the purpose other than for which the loan was sanctioned but were ultimately utilised for the stated end-use.
 - (e) Whether term loans taken

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were not applied for stated purpose during the year for any reason? If yes, mention the facts and amount. Also disclose the fact about utilization of term loan of earlier year in current year.

- (f) Whether the fund flow statement has been reviewed where one to one correlation was not possible.

Conclusion:

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

- (a) Whether movement of funds of company can be examined and verified and such movement also be supported by relevant documentation, direct relationship between particular funds and an asset from the balance sheet can be ascertained.
- (b) Whether trail is available to show that movement of source and application of funds and a direct relationship between them? If not, determine movement and application of funds on an overall basis.
- (c) Whether funds raised for short term have been applied for long-term requirements of the company?

Conclusion:

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- 4(xviii) **Whether the company has made any preferential allotment of shares to parties and companies covered in the Register maintained under Section 301 of the Act, and if so whether the price at which shares have been issued is prejudicial to the interest of the company.**
- (a) Whether pricing of shares in case of listed company allotted preferentially is in accordance with the guidelines issued by SEBI? If yes, it may be concluded that shares have been issued at a price which is not prejudicial to the interest of the Company.
- (b) In case of unlisted or private companies, where any of the four pricing methods (Net Asset Basis, Maintainable Profit Basis, Yield Basis & Discounted Cash flow Method) have been followed, it may be concluded that the share price is not prejudicial to the interest of the Company.
- (c) In case an expert opinion has been relied upon ensure compliance SA 620 "Using the work of expert"
- (d) Whether opinion is formed on the basis of the Order issued by the Government, state the fact of reliance on the Government Order.
- (e) Obtain a representation from the management as to why the company considers that the price charged is not prejudicial

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to the interest of the company.
If the explanation is not convincing, state that the price charged by the company is prejudicial to the interest of the company.

Conclusion:

4(xix) **Whether security or charge has been created in respect of debentures issued?**

- (a) Where the company has issued any debentures, examine the debenture trust deed executed under section 117A of the Act.
- (b) Whether proper security or charge has been created in favour of the debenture trust? Verify the relevant documents.
- (c) Whether provisions of Section 125 and 130 of the Companies Act, 1956 have been complied with regarding creation of charge?

Conclusion:

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

- (a) Whether complete disclosure of the end use of money raised by public issues has been made in the Financial Statements? If not, state the fact.
- (b) Whether the end use of money raised from public issues is capable of being determined? If not state the fact.

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- (c) Whether the end-use of money disclosed in the financial statements by way of a Note is significantly different from the actual end use? If so, state the fact.
- (d) Examine the various documents submitted to SEBI, offer document and also examine the report of board of directors, if available, to find out whether funds raised have been utilized for the purpose for which they were raised.
- (e) Whether a representation of the management has been obtained as to the completeness of the disclosures with regard to the end-use of money's raised by public issues?
- (f) Whether the fund flow statement has been reviewed where one to one correlation is not possible.
- (g) In case of a listed company where the issue size is more than Rs.500 crores ensure monetary agency is appointed

Conclusion:

- 4(xxi) **Whether any fraud on or by the company has been noticed or reported during the year. If yes, the nature and the amount involved is to be indicated.**
- (a) Has SA 240 been complied with?

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- (b) Examine the following to ascertain whether any fraud has been reported or noticed by the management?
- ◆ the reports of the internal Audit
 - ◆ the auditor should enquire from the management about any frauds on or by the company that it has noticed or that have been reported to it.
 - ◆ discuss the matter with other employees of the company.
 - ◆ examine the minutes book of the board meeting, audit committee etc., of the company in this regard.
- (c) Where any fraud on the company or by the company has been noticed or reported, determine the nature and amount of frauds and disclose the same. Obtain management representation to this effect.

Conclusion:

Discussed with.....
Designation.....
Date.....

**Illustrative List of Questions
For Evaluating Internal Controls¹⁹**

A. Purchases and Creditors

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

¹⁹ Extracts from "Internal Control Questionnaire", the Institute of Chartered Accountants of India. Members' attention is invited to para 6 of the Internal Control Questionnaire for the appropriate format of the Questionnaire.

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12. Do purchase orders contain the following minimum information:
 - (a) Name of supplier?
 - (b) Delivery terms?
 - (c) Quantity?
 - (d) Price?
 - (e) Freight terms?
 - (f) Payment terms?
 - (g) Any extra term as applicable?
13. Is revision of terms of purchase orders duly authorised?
14.
 - (a) Are copies of purchase orders and revisions forwarded to Accounts and Receiving Departments?
 - (b) If 'yes', do the copies show the quantities ordered?
 - (c) If 'no', is there an adequate procedure for the Receiving Department to be notified to accept deliveries?
15. Is a list of pending purchase orders compiled by the Purchase Department at least once every quarter?
16. Are the materials, supplies, etc., received only in the Receiving Department?
17. If they are received directly by User Department/ Processors/Customers, is there a procedure of obtaining acknowledgement for the quantity received and the condition of the goods?
18. Are persons connected with receipt of materials and the keeping of receiving records denied authority to issue purchase orders or to approve invoices?
19. Are materials, supplies inspected and counted, weighted or measured in the Receiving Department?
20. Are quantities and description checked against purchase order (or other form of notification) and goods inspected for condition?
21.
 - (a) Does the Receiving Department deliver or supervise the delivery of each item received to the proper Stores or Department location?

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- (b) Are acknowledgements obtained from suppliers for goods/containers returned to them?
- 22. Are all receipts of materials evidenced by pre-numbered Goods Received Notes?
- 23. Are copies of Goods Received Notes forwarded to Accounts Department and a list of goods received to Purchase Department?
- 24. Are all cases of materials returned, shortages and rejections advised to the Accounts Departments, for raising Debit Memos on suppliers or claim bills on carriers/insurance companies, as the case may be?
- 25. Are all debit notes, etc. –
 - (a) pre-numbered?
 - (b) numerically controlled?
 - (c) properly recorded (in the financial accounts or in memorandum registers, as the case may be)?
- 26. (a) Are all suppliers' invoices routed direct to the Accounts Department?
 - (b) Are they entered in a Bill Register before submitting them to other department for check and/or approval?
 - (c) Are advance and partial payments entered on the invoices before they are submitted to other department?
- 27. Does the system ensure that all invoices and credit notes received are duly processed?
- 28. In respect of raw materials and supplies, are reconciliation made of quantities and/or values received, as shown by purchase invoices, with receipts into stock records?
- 29. Are duplicate invoices marked immediately on receipt to avoid payment against them?
- 30. If payments are made against duplicate invoices even occasionally, are adequate precautions taken to avoid duplicate payments?
- 31. Does the Accounts Department match the invoices of suppliers with Goods Received Notes or acknowledgements received as per Q.17 and purchase orders?
- 32. (a) Are Goods Received Notes and receiving records regularly reviewed for items for which no invoices have been received?

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- (b) Are all such items investigated and is provision made for the liability in respect of such items?
- (c) Is such review/investigation done by a person independent of those responsible for the receipt and control of goods?
- 33. Do all invoices bear evidence of being checked for prices, freight terms, extensions and additions?
- 34. Is the relative purchase order attached to the invoice for payment?
- 35. Where the client both buys from and sells to a person regularly, is a periodic review made of all amounts due from that person to determine whether any set-off is necessary?
- 36. (a) Is a special request used for making payments in advance or against documents through Bank?
- (b) Thereafter, are the invoices processed in the normal course?
- 37. (a) Are all advance payments duly authorised by persons competent to authorise such payment?
- (b) Is a list of pending advances made at least every quarter and is a proper follow-up maintained?
- 38. Are all adjustments to creditors' accounts duly approved by those authorised in this behalf?
- 39. Is a list of employees, by designation, with limits of authority in respect of several matters referred to in this section maintained?
- 40. Are all suppliers' statements compared with ledger accounts?
- 41. Is there any follow-up action to investigate differences, if any, between the suppliers' statements and the ledger accounts?
- 42. Is a list of unpaid creditors prepared and reconciled periodically with the General Ledger Control account?
- 43. Is there a system of ensuring that cash discounts are availed of whenever offered?

B. Stocks

- 1. Are stocks stored in assigned areas?
- 2. If so, is access to these areas limited?
- 3. Are stocks insured against the following risks:

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- (a) fire?
 - (b) strike, riot and civil commotion?
 - (c) flood?
 - (d) hail damage where applicable?
4. If the answer to any of the above is negative, is it due to specific decision taken by a senior official?
 5. Is a record maintained for the insurance policies?
 6. Is the record reviewed periodically?
 7. Is there an official who decides on the value for which the stocks are to be insured?
 8. Is the adequacy of the insurance cover reviewed periodically?
 9. Are perpetual stock records kept for:
 - (a) raw materials?
 - (b) work-in-progress?
 - (c) finished goods?
 - (d) stores?
 10. Are they periodically reconciled with accounting records?
 11. Is there a system of perpetual inventory for stocks of:
 - (a) raw materials?
 - (b) work-in-progress?
 - (c) finished goods?
 - (d) stores?
 12. Where there is a system of perpetual inventory count:
 - (a) Is there a periodical report of shortages/excess?
 - (b) If so, are these differences investigated?
 - (c) Are these differences adjusted in the stock records and in the financial accounts?
 - (d) Is written approval obtained from a responsible official to adjust these differences?
 13. Are there norms for stock levels to be held?

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14. Is there a periodic reporting of:
 - (a) Slow-moving items?
 - (b) Damaged items?
 - (c) Obsolete items?
 - (d) Over-stocked items?
15. Is there a well-laid out written procedure for inventory count?
16.
 - (a) Are stocks physically verified once in a year?
 - (b) Is this done by a person independent of persons who are responsible for maintaining these records or the storekeeper?
 - (c) Are written instructions prepared for guidance of employees engaged in physical stock taking to cover:
 - (i) Proper identification and arrangement of stocks?
 - (ii) Cut-off points of receipts and deliveries?
 - (iii) Recording of the condition of the stocks?
 - (iv) Compliance with the conditions warranties in the relative insurance policies?
17. Are the physical inventory records, such as tags, cards, tally sheets, under numerical control?
18. Are the clerical steps in the preparation of stock sheets checked independently for:
 - (a) Summarisation of quantities?
 - (b) Unit rates?
 - (c) Additions?
 - (d) Extensions?
 - (e) Unit conversions?
 - (f) Summarisation of cards and/or sheets?
19. Are the quantities shown in the stock sheets compared with the quantities declared to banks or insurers, where possible?

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20. If there are significant variations between the actual stocks and book stocks:
 - (a) Are they investigated?
 - (b) Is a recount made where necessary?
 - (c) Is the stock book corrected with proper authority?
21. Are the following stocks checked:
 - (1) Physically by the company's staff?
 - (2) With certificates from concerned holders of the stocks?
 - (a) Stock in public warehouses?
 - (b) Stocks with consignees?
 - (c) Stocks with sub-contractors for fabrication, etc.?
 - (d) Stocks with customers, on approval?
 - (e) Stocks in bonded warehouses?
 - (f) Stocks pledged with third parties?
22. Is stock on hand relating to third parties, such as customer's stocks and consignments physically segregated or properly identified?
23. Are the procedures relating to record keeping and stock-taking made applicable to third also?
24. Are confirmations obtained from the third parties for stocks held on their behalf?
25. Are records maintained for:
 - (a) Scrap available for sale?
 - (b) By-products?
 - (c) Returnable containers?
26. Is there an adequate recording procedure for:
 - (a) Stocks with outsiders?
 - (b) Stocks of outsiders held by the company?
27. Is there a system of job/production orders for control of production?
28. Does the storekeeper issue raw materials, stores etc., only against Requisition Notes signed by properly authorised officials?

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29. Does the storekeeper acknowledge in writing the quantity of finished goods received from the Factory?
30. Is the stock record periodically checked with such acknowledgments?
31. Does the cost system provide for obtaining units or job order costs for:
 - (a) Work-in-progress?
 - (b) Finished goods?
32. Is the cost system integrated with/or reconciled to General Ledger controls as regards:
 - (i) Material?
 - (ii) Labour?
 - (iii) Overheads?
33. Does the cost system provide for detailed units or job order costs in terms of:
 - (i) Raw material costs?
 - (ii) Direct labour?
 - (iii) Overheads?
 - (iv) Physical quantities?
 - (v) Unit rates?
34. Are similar records kept for service departments also?
35. Are overhead rates:
 - (a) Reviewed periodically by designated employees?
 - (b) Adjusted in the light of current experience?
36. Are separate control accounts maintained for stock of:
 - (a) Work-in-progress?
 - (b) Finished goods?
37. In a job order industry, are the estimates of costs compared with actual costs?
38. If standard cost system exists:
 - (i) Are variances investigated?
 - (ii) Are standards reviewed periodically?

C. Fixed Assets

Purchases and Disposals

1. Are budgets for capital expenditure approved by the Board?
2. Are approved budgets communicated in writing to:
 - (a) Purchase Department?
 - (b) Accounts Department?
 - (c) Department originating the request?
3. Are written authorisations required for incurring capital expenditure for items included in the budget?
4. Is the authority to incur capital expenditure restricted to specified officials?
5. Are purchases of capital items subject to same controls as are applicable to purchases of raw materials, stores etc.?
6. Are receipts of capital items subject to same procedures as applicable to raw materials, stores, etc.?
7. Is there proper check to see that amounts expended do not exceed the amount authorised?
8. Are supplemental authorisation required for excess expenditures?
9. Is there an established procedure for moving plant and machinery from the location to another?
10.
 - (i) Is written authority required for:
 - (a) scrapping fixed assets?
 - (b) selling fixed assets?
 - (ii) Is the authority to permit scrapping/selling of fixed assets restricted to specified officials
 - (iii) Are limits specified in this regard?
 - (iv) Are sales of fixed assets subject to same procedures as are applicable to sales of finished goods?
11. Are reports issued promptly in respect of:
 - (a) units sold?
 - (b) units scrapped?

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- (c) units moved from one location to another?

Records

12. Are fixed assets under construction:
 - (a) subject to separate control account in General Ledger?
 - (b) controlled by job number?
13. Is expenditure on wages, materials and stores charged to capital account on reasonable basis?
14. Is there any official responsible for ensuring that allocation of expenditure between capital and revenue is in accordance with the company's accounting policy?
15. Is a register of all fixed assets (including fully depreciated assets) maintained?
16. Is the register regularly written up throughout the year?
17. Is the register periodically tallied with the financial accounts?
18. Is the following information available, in the register?
 - (a) Supplier's name
 - (b) Date of purchase.
 - (c) Cost (including additions, improvements, exchange rate adjustments etc.).
 - (d) Location and identification number
 - (e) Rate of depreciation and estimate life
 - (f) Accumulated depreciation
 - (g) Estimated salvage value
19. Is a record maintained of equipment used by the company, but owned by others?
20. Is the register of patents or trade marks maintained up-to-date?
21. Is there a list of title deeds for the landed properties and buildings?
22. Are title deeds of properties kept in safe place?
23. If they are lodged as security, are certificates obtained to that effect periodically?

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24. Are registration books of vehicles periodically verified?

Verification

25. Are fixed assets verified periodically?
26. Is there a written procedure for such verification?
27. Does the procedure provide for verification/confirmation of fixed assets with third parties?
28. Does the procedure provide for verification of compliance with the warranties and conditions in the relevant insurance policies?
29. Are reports prepared on such verification?
30. Do such reports indicate damaged/obsolete items of fixed assets?
31. (a) Are discrepancies disclosed by such reports investigated?
(b) Are the records and financial accounts corrected, with proper authority?
32. Are damaged/obsolete items disclosed by such reports, removed from the records and financial accounts with proper authority?

Moulds, Patterns, Jigs, Fixtures, Tools etc.

33. Is there satisfactory control over the acquisition and write-off of such items?
34. Are there physical safeguards against theft or loss of tools and other movable equipment?
35. Are records maintained for:
(a) items treated as stock?
(b) items treated as fixed assets?

Insurance

36. (i) Are the following risks covered in respect of buildings and machinery:
(a) Fire
(b) Strike, riot and civil commotion
(c) Flood
(d) Earthquake

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- (e) Nuclear risks
 - (f) Malicious damage
 - (g) War risks
 - (ii) If the answer to any of the above is negative, is it due to a specific decision taken by a senior official?
37. Is there an adequate procedure to ensure that assets acquired between two renewal dates are also covered by insurance?
38. Is there an official who decides on the value for which policies are taken?
39. Are the fixed assets insured at re-instatement basis?
40. Does the official who decides on the value for which policies are taken, review periodically the adequacy of the insurance cover?
41. (i) Is there loss-of-profits insurance cover?
- (ii) Is there machinery-breakdown insurance cover?
- (iii) If the answer to (i) or (ii) is negative is it due to a specific decision taken by a senior official?

D. Sales and Debtors

1. Are standard price lists maintained?
2. Are prices which are not based on standard price lists, required to be approved by a senior executive outside the Sales Department?
3. Are written orders from customers received in all cases?
4. If oral/telephonic orders are received, are they recorded immediately in the client's standard forms?
5. Is there a numerical control of all customers' orders?
6. Are credit limits fixed in respect of individual customers?
7. Are these limits approved by an official independent of the Sales Department?
8. Are credit limits reviewed periodically?
9. Are customers' credit limits checked before orders are accepted?
10. Is this done by a person independent of the Sales Department?
11. If sales to employees are made at concessional prices:

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- (a) Is there a limit to the value of such sales?
- (b) Is there an adequate procedure to see that these limits are not exceeded?
- (c) Are the amounts recovered in accordance with the terms of sale?
- 12. Are dispatches of goods authorised only by Dispatch Notes/Gate Passes or similar documents?
- 13. Do such Dispatch Notes/Gate Passes or similar documents bear preprinted numbers?
- 14. Are they under numerical control?
- 15. Are they prepared by a person independent of:
 - (a) the Sales Department?
 - (b) the processing of invoices?
- 16. Except when all documents are prepared in one operation, are the Dispatch Notes/Gate Passes matched with:
 - (a) Excise Duty records?
 - (b) Sales invoices?
 - (c) Freight payable to carriers (where applicable)
- 17. Are unmatched Dispatch Notes/Gate Passes reviewed periodically?
- 18. Are the goods actually dispatched checked independently with the Dispatch Notes/Gate Passes and Customer's Orders?
- 19. Are acknowledgements obtained from the customers for the goods delivered?
- 20. Are the customers' orders marked for goods delivered?
- 21. Are shortages in goods delivered to the customers investigated?
- 22. Are credits to customers for shortages, breakages and losses in transit match with claims lodged against carriers/insurers?
- 23. Are sales invoices pre-numbered?
- 24. Are all invoice numbers accounted for?
- 25. Are invoices checked for:
 - (a) prices?

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- (b) calculations (including excise duty and sales tax)?
- (c) terms of payment?
- 26. Are 'no charge' invoices authorised by a person independent of the custody of goods or cash?
- 27. Are invoices mailed direct to the customers promptly?
- 28. Are credits customers for remittances posted only from the entries in the cash book (or equivalent record)?
- 29. Does cashier notify immediately:
 - (a) Sales Department,
 - (b) Debtors' Ledger Section and
 - (c) Credit Controller:
 - (i) of all dishonoured cheques or other negotiable instruments?
 - (ii) of all documents sent through bank but not returned by the customers?
- 30. Is immediate follow-up action taken on such notification?
- 31. Are bills of exchange (or other negotiable instruments) accepted by customers recorded?
- 32. Are the bills of exchange, etc., as per such record periodically verified with the bills on hand?
- 33. (a) Is a record of customers' claims maintained?
(b) Are such claims properly dealt with in the accounts?
- 34. Does the Receiving Department count, weigh or measure the goods returned by customers?
- 35. Does the Receiving Department record them on a Sales Returns Note?
- 36. Are copies of Sales Returns Notes sent to:
 - (a) Customer?
 - (b) Sales Department?
 - (c) Debtors' Ledger Section?
- 37. Are the returned goods taken into stock immediately?
- 38. Is a Credit Note issued to a customer for the goods returned?

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39. Are all Credit Notes pre-numbered?
40. Are Credit Notes numerically controlled?
41. Are Credit Notes authorised by a person independent of:
 - (a) Custody of goods?
 - (b) Cash receipts?
 - (c) Debtors' ledger?
42. Are Credit Notes:
 - (a) compared with Sales Returns Notes or other substantiating evidence?
 - (b) checked for prices?
 - (c) checked for calculations?
43. Are corresponding recoveries of sales commissions made when Credit Notes are issued to customers?
44. Are units of sales (as per sales invoices) correlated and reconciled with the purchases (or production) and stocks on hand?
45. Is the Sales Ledger balanced periodically and tallied with the General Ledger Control account?
46. Are ageing schedules prepared periodically?
47. Are they reviewed by a responsible person?
48. Are statements of accounts regularly sent to all customers?
49. Are the statements checked with the Debtors' Ledger before they are issued?
50. Are the statements mailed by a person independent of the ledger-keeper?
51. Are confirmations of balances obtained periodically?
52. Are the confirmations verified by a person independent of the ledger-keeper and the person preparing the statement?
53. Is special approval required for:
 - (a) Payment of customers' credit balances?
 - (b) Writing off bad debts?
54. Is any accounting control kept for bad debts written off?

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- 55. Is any follow-up action taken for recovering amounts written off?
- 56. In the case of export sales:
 - (a) is a record maintained of import entitlements due?
 - (b) does the record cover the utilisation/disposal of such entitlements?
 - (c) is there a procedure to ensure that claims for incentives etc., receivable are made in time?
- 57. Are sales of scrap and wastage subject to the same procedures and controls as sales of finished goods?

**Text of Certain Relevant Sections
Referred to in the Statement**

A From the Companies Act, 1956

58A. Deposits not to be invited without issuing an advertisement.

- (1) The Central Government may, in consultation with the Reserve Bank of India, prescribe 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.
- (2) No company shall invite, or allow any other person to invite or cause to be invited on its behalf, any deposit unless –
 - (a) such deposit is invited or is caused to be invited in accordance with the rules made under sub-section (1),
 - (b) an advertisement, including therein a statement showing the financial position of the company, has been issued by the company in such form and in such manner as may be prescribed, and
 - (c) the company is not in default in the repayment of any deposit or part thereof and any interest thereupon in accordance with the terms and conditions of such deposit.
- (3)
 - (a) Every deposit accepted by a company at any time before the commencement of the Companies (Amendment) Act, 1974, in accordance with the directions made by the Reserve Bank of India under Chapter III B of the Reserve Bank of India Act, 1934 (2 of 1934), shall, unless renewed in accordance with clause (b), be repaid in accordance with the terms and conditions of such deposit.
 - (b) No deposit referred to in clause (a) shall be renewed by the company after the expiry of the term thereof unless the deposit is such that it could have been accepted if the rules made under sub-section (1) were in force at the time when the deposit was initially accepted by the company.
 - (c) Where, before the commencement of the Companies (Amendment) Act, 1974, any deposit was received by a company

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in contravention of any direction made under Chapter IIIB of the Reserve Bank of India Act, 1934 (2 of 1934), repayment of such deposit shall be made in full on or before the 1st day of April, 1975, and such repayment shall be without prejudice to any action that may be taken under the Reserve Bank of India Act, 1934 for the acceptance of such deposit in contravention of such direction.

- (3A) Every deposit accepted by a company after the commencement of the Companies (Amendment) Act, 1988, shall, unless renewed in accordance with the rules made under sub-section (1), be repaid in accordance with the terms and conditions of such deposit.
- (4) Where any deposit is accepted by a company after the commencement of the Companies (Amendment) Act, 1974, in contravention of the rules made under sub-section (1), repayment of such deposit shall be made by the company within thirty days from the date of acceptance of such deposit or within such further time, not exceeding thirty days, as the Central Government may, on sufficient cause being shown by the company, allow.
- (5) Where a company omits or fails to make repayment of a deposit in accordance with the provisions of clause (c) of sub-section (3), or in the case of a deposit referred to in sub-section (4), within the time specified in that sub-section,—
 - (a) the company shall be punishable with fine which shall not be less than twice the amount in relation to which the repayment of the deposit, has not been made, and out of the fine, if realised, an amount equal to the amount in relation to which the repayment of deposit has not been made, shall be paid by the Court, trying the offence, to the person to whom repayment of the deposit was to be made, and on such payment, the liability of the company to make repayment of the deposit shall, to the extent of the amount paid by the Court, stand discharged;
 - (b) every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to five years and shall also be liable to fine.
- (6) Where a company accepts or invites, or allows or causes any other person to accept or invite on its behalf, any deposit in excess of the limits prescribed under sub-section (1) or in contravention of the manner or

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condition prescribed under that sub-section or in contravention of the provisions of sub-section (2), as the case may be, -

- (a) the company shall be punishable,-
 - (i) where such contravention relates to the acceptance of any deposit, with fine which shall not be less than an amount equal to the amount of the deposit so accepted;
 - (ii) where such contravention relates to the invitation of any deposit, with fine which may extend to ten lakh rupees but shall not be less than fifty thousand rupees;
- (b) every officer of the company who is in default shall be punishable with imprisonment for a term which may extend to five years and shall also be liable to fine.

- (7) (a) Nothing contained in this section shall apply to, -
 - (i) a banking company, or
 - (ii) such other company as the Central Government may, after consultation with the Reserve Bank of India, specify in this behalf.
- (b) Except the provisions relating to advertisement contained in clause (b) of sub-section (2), nothing in this section shall apply to such classes of financial companies as the Central Government may, after consultation with the Reserve Bank of India, specify in this behalf.

- (8) The Central Government may, if it considers it necessary for avoiding any hardship or for any other just and sufficient reason, by order, issued either prospectively or retrospectively from a date not earlier than the commencement of the Companies (Amendment) Act, 1974 (41 of 1974), grant extension of time to a company or class of companies to comply with, or exempt any company or class of companies from, all or any of the provisions of this section either generally or for any specified period subject to such conditions as may be specified in the order:

Provided that no order under this sub-section shall be issued in relation to a class of companies except after consultation with the Reserve Bank of India.

- (9) Where a company has failed to repay any deposit or part thereof in accordance with the terms and conditions of such deposit, the Tribunal,

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may, if it is satisfied, either on its own motion or on the application of the depositor, that it is necessary so to do to safeguard the interests of the company, the depositors or in the public interest, direct, by order, the company to make repayment of such deposit or part thereof forthwith or within such time and subject to such conditions as may be specified in the order.

Provided that the Tribunal may, before making any order under this sub-section give a reasonable opportunity of being heard to the company and the other persons interested in the matter.

- (10) Whoever fails to comply with any order made by the Tribunal under sub-section (9) shall be punishable with imprisonment may extend to three years and shall also be liable to a fine of not less than rupees five hundred for every day during which such non-compliances continues.
- (11) A depositor may, at any time, make a nomination and the provisions of sections 109A and 109B shall, as far as may be, apply to the nomination made under this sub-section.

Explanation: For the purposes of this section “deposit” means any deposit of money with, and includes any amount borrowed by, a company but shall not include such categories of amount as may be prescribed in consultation with the Reserve Bank of India.

58AA. Small Depositors

- (1) Every company, which accepts deposits from small depositors, shall intimate to the [Tribunal] any default made by it in repayment of any such deposits or part thereof or any interest thereupon.
- (2) The intimation under sub-section (1) shall, -
 - (a) be given within sixty days from the date of default,
 - (b) include particulars in respect of the names and addresses of each small depositor, the principal sum of deposits due to them and interest accrued thereupon.

Explanation: For the removal of doubts, it is hereby declared that the intimation under this section shall be given on monthly basis.

- (3) Where a company has made a default in repayment of any deposit or part thereof or any interest thereupon to a small depositor, the Tribunal, on receipt of intimation under sub-section (1) shall, -

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- (a) exercise, on its own motion, powers conferred upon it by sub-section (9) of section 58A;
- (b) pass an appropriate order within a period of thirty days from the date of receipt of intimation under sub-section (1):

Provided that the Tribunal may pass order after expiry of the period of thirty days, after giving the small depositors an opportunity of being heard:

Provided further that it shall not be necessary for a small depositor to be present at the hearing of the proceeding under this sub-section.

- (4) No company shall, at any time, accept further deposits from small depositors, unless each small depositor, whose deposit has matured, had been paid the amount of the deposit and the interest accrued thereupon:

Provided that nothing contained in this sub-section shall apply to—

- (a) any deposit which has been renewed by the small depositor voluntarily; or
 - (b) any deposit, whose repayment has become impracticable due to the death of the small depositor or whose repayment has been stayed by a competent court or authority.
- (5) Every company, which has on any occasion made a default in the repayment of a deposit or part thereof or any interest thereupon to a small depositor, shall state, in every future advertisement and application form inviting deposits from the public, the total number of small depositors and amount due to them in respect of which such default has been made.
- (6) Where any interest accrued on deposits of the small depositors has been waived, the fact of such waiver shall be mentioned by the company in every advertisement and application form inviting deposits issued after such waiver.
- (7) Where a company had accepted deposits from small depositors and subsequent to such acceptance of deposits, obtains funds by taking a loan for the purposes of its working capital from any bank, it shall first utilise the funds so obtained for the repayment of any deposit or any part thereof or any interest thereupon to the small depositor before applying such funds for any other purpose.

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- (8) Every application form, issued by a company to a small depositor for accepting deposits from him, shall contain a statement to the effect that the applicant had been apprised off –
- (a) every past default by the company in the repayment of deposit or interest thereon, if any, such default has occurred; and
 - (b) the waiver of interest under sub-section (6), if any, and reasons therefor.
- (9) Whoever knowingly fails to comply with the provisions of this section or comply with any order of the Tribunal shall be punishable with imprisonment which may extend to three years and shall also be liable to fine for not less than five hundred rupees for every day during which such non-compliance continues.
- (10) If a company or any other person contravenes any provision of this section, every person, who at the time the contravention was committed, was a director of the company, as well as the company, shall be deemed to be guilty of the offence and shall be liable to be proceeded against and punished accordingly.
- (11) The provisions of section 58A shall, as far as may be, apply to the deposits made by a small depositor under this section.

Explanation: For the purposes of this section, "a small depositor" means 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.

295. Loans to directors, etc.

- (1) Save as otherwise provided in subsection (2), no company (hereinafter in this section referred to as "the lending company" without obtaining the previous approval of the Central Government in that behalf shall, directly or indirectly, make any loan to, or give any guarantee or provide any security in connection with a loan made by any other person to, or to any other person by -
- (a) any director of the lending company, or of a company which is its holding company or any partner or relative of any such director;
 - (b) any firm in which any such director or relative is a partner;

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- (c) any private company of which any such director is a director or member;
 - (d) any body corporate at a general meeting of which not less than twenty-five per cent of the total voting power may be exercised or controlled by any such director, or by two or more such directors, together; or
 - (e) any body corporate, the Board of directors, managing director, or manager whereof is accustomed to act in accordance with the directions or instructions of the Board, or of any director or directors, of the lending company.
- (2) Sub-section (1) shall not apply to-
- (a) any loan made, guarantee given or security provided-
 - (i) by a private company unless it is a subsidiary of a public company, or
 - (ii) by a banking company;
 - (b) any loan made by a holding company to its subsidiary company;
 - (c) any guarantee given or security provided by a holding company in respect of any loan made to its subsidiary company.
- (3) Where any loan made, guarantee given or security provided by a lending company and outstanding at the commencement of this Act could not have been made, given or provided, without the previous approval of the Central Government, if this section has then been in force, the lending company shall, within six months from the commencement of this Act or such further time not exceeding six months as the Central Government may grant for that purpose, either obtain the approval of the Central Government to the transaction or enforce the repayment of the loan made, or in connection with which the guarantee was given or the security was provided, notwithstanding any agreement to the contrary.
- (4) Every person who is knowingly a party to any contravention of sub-section (1) or (3), including in particular any person to whom the loan is made or who has taken the loan in respect of which the guarantee is given or the security is provided, shall be punishable either with fine which may extend to fifty thousand rupees or with simple imprisonment for a term which may extend to six months.

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Provided that where any such loan, or any loan in connection with which any such guarantee of security has been given or provided by the lending company, has been repaid in full, no punishment by way of imprisonment shall be imposed under this sub-section; and where the loan has been repaid in part, the maximum punishment which may be imposed under this sub-section by way of imprisonment shall be proportionately reduced.

- (5) All persons who are knowingly parties to any contravention of sub-section (1) or (3) shall be liable, jointly and severally, to the lending company for the repayment of the loan or for making good the sum which the lending company may have been called upon to pay in virtue of the guarantee given of the security provided by such company.
- (6) No officer of the lending company or of the borrowing body corporate shall be punishable under sub-section (4) or shall incur the liability referred to it sub-section (5) in respect of any loan made, guarantee given or security provided after the 1st day of April, 1956 in contravention of clause (d) or (e) of sub-section (1) unless at the time when the loan was made, the guarantee was given or the security was provided by the lending company, he knew or had express notice that that clause was being contravened thereby.

297. Board's sanction to be required for certain contracts in which particular directors are interested

- (1) Except with the consent of the Board of directors of a company, a director of the company or his relative, a firm in which such a director or relative is a partner, any other partner in such a firm, or a private company of which the director is a member or director, shall not enter into any contract with the company-
 - (a) for the sale, purchase or supply of any goods, material or services; or
 - (b) after the commencement of this Act, for underwriting the subscription of any shares in, or debentures of, the company:

Provided that in the case of a company having a paid-up share capital of not less than rupees one crore, no such contract shall be entered into except with the previous approval of the Central Government.

- (2) Nothing contained in clause (a) of sub-section (1) shall affect-
 - (a) the purchase of goods and materials from the company, or the sale of goods and materials to the company, by any director,

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relative, firm, partner or private company as aforesaid for cash at prevailing market prices; or

- (b) any contract or contracts between the company on one side and any such director, relative, firm, partner or private company on the other for sale, purchase or supply of any goods, materials and services in which either the company or the director, relative, firm, partner or private company, as the case may be, regularly trades or does business.

Provided that such contract or contracts do not relate to goods and materials the value of which, or services the cost of which, exceeds five thousand rupees in the aggregate in any year comprised in the period of the contract or contracts; or

- (c) in the case of a banking or insurance company any transaction in the ordinary course of business of such company with any director, relative, firm, partner or private company as aforesaid.
- (3) Notwithstanding anything contained in sub-sections (1) and (2) a director, relative, firm, partner or private company as aforesaid may, in circumstances of urgent necessity, enter, without obtaining the consent of the Board, into any contract with the company for the sale, purchase or supply of any goods, materials or services even if the value of such goods or cost of such services exceeds five thousand rupees in the aggregate in any year comprised in the period of the contract; but in such a case, the consent of the Board shall be obtained at a meeting within three months of the date on which the contract was entered into.
 - (4) Every consent of the Board required under this section shall be accorded by a resolution passed at a meeting of the Board and not otherwise; and the consent of the Board required under sub-section (1) shall not be deemed to have been given within the meaning of that sub-section unless the consent is accorded before the contract is entered into or within three months of the date on which it was entered into.
 - (5) If consent is not accorded to any contract under this section, anything done in pursuance of the contract shall be voidable at the option of the Board.
 - (6) Nothing in this section shall apply to any case where the consent has been accorded to the contract before the commencement of the Companies (Amendment) Act, 1960.

299. Disclosure of interests by director

- (1) Every director of a company who is in any way, whether directly or indirectly, concerned or interested in a contract or arrangement, or proposed contract or arrangement, entered into or to be entered into, by or on behalf of the company, shall disclose, the nature of his concern or interest at a meeting of the Board of directors.
- (2)
 - (a) In the case of a proposed contract or arrangement the disclosure required to be made by a director under sub-section (1) shall be made at the meeting of the Board at which the question of entering into the contract or arrangement is first taken into consideration, or if the director was not, at the date of that meeting, concerned or interested in the proposed contract or arrangement, at the first meeting of the Board held after he becomes so concerned or interested.
 - (b) In the case of any other contract or arrangement, the required disclosure shall be made at the first meeting of the Board held after the director becomes concerned or interested in the contract or arrangement.
- (3)
 - (a) For the purposes of sub-sections (1) and (2), a general notice given to the Board by a director, to the effect that he is a director or a member of a specified body corporate or is a member of a specified firm and is to be regarded as concerned or interested in any contract or arrangement which may, after the date of the notice, be entered into with that body corporate or firm, shall be deemed to be a sufficient disclosure of concern or interest in relation to any contract or arrangement so made.
 - (b) Any such general notice shall expire at the end of the financial year in which it is given, but may be renewed for further periods of one financial year at a time, by a fresh notice given in the last month of the financial year in which it would otherwise expire.
 - (c) No such general notice, and no renewal thereof, shall be of effect unless either it is given at a meeting of the Board, or the director concerned takes reasonable steps to secure that it is brought up and read at the first meeting of the Board after it is given.
- (4) Every director who fails to comply with sub-section (1) or (2) shall be punishable with fine which may extend to fifty thousand rupees.

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- (5) Nothing in this section shall be taken to prejudice the operation of any rule of law restricting a director of a company from having any concern or interest in any contracts or arrangements with the company.
- (6) Nothing in this section shall apply to any contract or arrangement entered into or to be entered into between two companies where any of the directors of the one company or two or more of them together holds or hold not more than two per cent of the paid-up share capital in the other company.

301. Register of contracts, companies and firms in which directors are interested

- (1) Every company shall keep one or more registers in which shall be entered separately particulars of all contracts or arrangements to which section 297 or section 299 applies, including the following particulars to the extent they are applicable in each case, namely:
 - (a) the date of the contract or arrangement;
 - (b) the names of the parties thereto;
 - (c) the principal terms and conditions thereof,
 - (d) in the case of a contract to which section 297 applies or in the case of a contract or arrangement to which sub-section (2) of section 299 applies, the date on which it was placed before the Board;
 - (e) the names of the directors voting for and against the contract or arrangement and the names of those remaining neutral.
- (2) Particulars of every such contract or arrangement to which section 297 or, as the case may be, sub-section (2) of section 299 applies, shall be entered in the relevant register aforesaid:
 - (a) in the case of a contract or arrangement requiring the Board's approval, within seven days (exclusive of public holidays) of the meeting of the Board at which the contract or arrangement is approved,
 - (b) in the case of any other contract or arrangement, within seven days of the receipt at the registered office of the company of the particulars of such other contract or arrangement or within thirty days of the date of such other contract or arrangement whichever is later, and the register shall be placed before the next meeting of

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the Board and shall then be signed by all the directors present at the meeting.

- (3) The register aforesaid shall also specify, in relation to each director of the company, the names of the firms and bodies corporate of which notice has been given by him under sub-section (3) of section 299.

(3A) Nothing in sub-sections (1), (2) and (3) shall apply-

- (a) to any contract or arrangement for the sale, purchase or supply of any goods, materials or services if the value of such goods and materials or the cost of such services does not exceed one thousand rupees in the aggregate in any year; or
 - (b) to any contract or arrangement (to which section 297 or, as the case may be, section 299 applies) by a banking company for the collection of bills in the ordinary course of its business or to any transaction referred to in clause (c) or sub-section (2) of section 297.
- (4) If default is made in complying with the provisions of sub-section (1), (2) or (3), the company, and every officer of the company who is in default, shall, in respect of each default, be punishable with fine which may extend to five thousand rupees.
- (5) The register aforesaid shall be kept at the registered office of the company; and it shall be open to inspection at such office, and extracts may be taken therefrom and copies thereof may be required, by any member of the company to the same extent, in the same manner, and on payment of the same fee, as in the case of the register of members of the company; and the provisions of section 163 shall apply accordingly.

372A. Inter-corporate loans and investments

- (1) No company shall, directly or indirectly-
- (a) make any loan to any other body corporate;
 - (b) give any guarantee or provide security, in connection with a loan made by any other person to, or to any other person by, any body corporate; and
 - (c) acquire, by way of subscription, purchase or otherwise the securities of any other body corporate, exceeding sixty per cent of its paid-up share capital and free reserves, or one hundred per cent of its free reserves, whichever is more:

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Provided that where the aggregate of the loans and investments so far made, the amounts for which guarantee or security so far provided to or in all other bodies corporate, along with the investment, loan, guarantee or security proposed to be made or given by the Board, exceeds the aforesaid limits, no investment or loan shall be made or guarantee shall be given or security shall be provided unless previously authorised by a special resolution passed in a general meeting:

Provided further that the Board may give guarantee, without being previously authorised by a special resolution, if,-

- (a) a resolution is passed in the meeting of the Board authorising to give guarantee in accordance with the provisions of this section;
- (b) there exists exceptional circumstances which prevent the company from obtaining previous authorisation by a special resolution passed in a general meeting for giving a guarantee; and
- (c) the resolution of the Board under clause (a) is confirmed within twelve months, in a general meeting of the company or the annual general meeting held immediately after passing of the Board's resolution, whichever is earlier:

Provided also that the notice of such resolution shall indicate clearly the specific limits, the particulars of the body corporate in which the investment is proposed to be made or loan or security or guarantee to be given, the purpose of the investment, loan or security or guarantee, specific sources of funding and such other details.

- (2) No loan or investment shall be made or guarantee or security given by the company unless the resolution sanctioning it is passed at a meeting of the Board with the consent of all the directors present at the meeting and the prior approval of the public financial institution referred to in section 4A, where any term loan is subsisting, is obtained.

Provided that prior approval of a public financial institution shall not be required where the aggregate of the loans and investments so far made, the amounts for which guarantee or security so far provided to or in all other bodies corporate, alongwith the investments, loans, guarantee or security proposed to be made or given does not exceed the limit of sixty per cent specified in sub-section (1), if there is no default in repayment of loan instalments or payment of interest thereon as per the terms and conditions of such loan to the public financial institution.

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- (3) No loan to any body corporate shall be made at a rate of interest lower than the prevailing bank rate, being the standard rate made public under section 49 of the Reserve Bank of India Act, 1934. (2 of 1934)
- (4) No company, which has defaulted in complying with the provisions of section 58A, shall, directly or indirectly,-
 - (a) make any loan to any body corporate;
 - (b) give any guarantee or provide security in connection with a loan made by any other person to, or to any other person by, any body corporate; and
 - (c) acquire, by way of subscription, purchase or otherwise the securities of any other body corporate, till such default is subsisting.
- (5) (a) Every company shall keep a register showing the following particulars in respect of every investment or loan made, guarantee given or security provided by it in relation to any body corporate under sub-section (1), namely:
 - (i) the name of the body corporate;
 - (ii) the amount, terms and purpose of the investment or loan or security or guarantee;
 - (iii) the date on which the investment or loan has been made; and
 - (iv) the date on which the guarantee has been given or security has been provided in connection with a loan.
 - (b) The particulars of investment, loan, guarantee or security referred to in clause (a) shall be entered chronologically in the register aforesaid within seven days of the making of such investment or loan, or the giving of such guarantee or the provision of such security.
- (6) The register referred to in sub-section (5) shall be kept at the registered office of the company concerned and-
 - (a) shall be open to inspection at such office; and
 - (b) extracts may be taken therefrom and copies thereof may be required,

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by any member of the company to the same extent, in the same manner, and on payment of the same fees as in the case of the register of members of the company, and the provisions of section 163 shall apply accordingly.

- (7) The Central Government may, prescribe guidelines for the purposes of this section.
- (8) Nothing contained in this section shall apply,-
 - (a) to any loan made, any guarantee given or any security provided or any investment made by-
 - (i) a banking company, or an insurance company, or a housing finance company in the ordinary course of its business, or a company established with the object of financing industrial enterprises or of providing infrastructural facilities;
 - (ii) a company whose principal business is the acquisition of shares, stock, debentures or other securities;
 - (iii) a private company, unless it is a subsidiary of a public company;
 - (b) to investment made in shares allotted in pursuance of clause (a) of subsection (1) of section 81;
 - (c) to any loan made by a holding company to its wholly owned subsidiary;
 - (d) to any guarantee given or any security provided by a holding company in respect of loan made to its wholly owned subsidiary; or
 - (e) to acquisition by a holding company, by way of subscription, purchases or otherwise, the securities of its wholly owned subsidiary.
- (9) If default is made in complying with the provisions of this section, other than sub-section (5), the company and every officer of the company who is in default shall be punishable with imprisonment which may extend to two years or with fine which may extend to fifty thousand rupees:

Provided that where any such loan or any loan in connection with which any such guarantee or security has been given, or provided by the company, has been repaid in full, no punishment by way of imprisonment

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shall be imposed under this sub-section, and where such loan has been repaid in part, the maximum punishment which may be imposed under this sub-section by way of imprisonment shall be appropriately reduced

Provided further that all persons who are knowingly parties to any such contravention shall be liable, jointly and severally, to the company or the repayment of the loan or for making good the same which the company may have been called upon to pay by virtue of the guarantee given or the securities provided by such company.

- (10) If default is made in complying with the provisions of sub-section (5), the company and every officer of the company who is in default shall be punishable with fine which may extend to five thousand rupees and also with a further fine which may extend to five hundred rupees for every day after the first day during which the default continues.

Explanation: For the purposes of this section,-

- (a) "loan" includes debentures or any deposit of money made by one company, with another company, not being a banking company;
- (b) "free reserves" means those reserves which, as per the latest audited balance sheet of the company, are free for distribution as dividend and shall include balance to the credit of the securities premium account but shall not include share application money.

(B) From the Reserve Bank of India Act, 1934

45MA. Powers and duties of auditors

- (1) It shall be the duty of an auditor of a non-banking institution to inquire whether or not the non-banking institution has furnished to the bank such statements, information or particulars relating to or connected with deposits received by it, as are required to be furnished under this chapter, and the auditor shall, except where he is satisfied on such inquiry that the non-banking institution has furnished such statements, information or particulars, make a report to the bank giving the aggregate amount of such deposits held by the non-banking institution.
- (1A) The bank may, on being satisfied that it is necessary so to do, in the public interest or in the interest of the depositors or for the purpose of proper assessment of the books of accounts, issue directions to any non-banking financial company or any class of non-banking financial companies or non-banking financial companies generally or to the auditors of such non-banking financial company or companies relating to

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balance sheet, profit and loss account, disclosure of liabilities in the books of accounts or any matter relating thereto.

- (2) Where, in the case of a non-banking financial company the auditor has made, or intends to make, a report to the bank under sub-section (1), he shall include in his report under sub-section (2) of section 227 of the Companies Act, 1956 (1 of 1956), the contents of the report which he has made, or intends to make, to the bank.
- (3) Where the bank is of the opinion that it is necessary so to do in the public interest or in the interest of the non-banking financial company, or in the interest of depositors of such company it may at any time by order direct that a special audit of the accounts of the non-banking financial company in relation to any such transaction or class of transactions or for such period or periods, as may be specified in the order, shall be conducted and the bank may appoint an auditor or auditors to conduct such special audit and direct the auditor or the auditors to submit the report to it.
- (4) The remuneration of the auditors as may be fixed by the bank, having regard to the nature and volume of work involved in the audit and the expenses of or incidental to the audit, shall be borne by the non-banking financial company so audited.

45MB. Power of bank to prohibit acceptance of deposit and alienation of assets

- (1) If any non-banking financial company violates the provisions of any section or fails to comply with any direction or order given by the bank under any of the provisions of this Chapter, the bank may prohibit the non-banking financial company from accepting any deposit.
- (2) Notwithstanding anything to the contrary contained in any agreement or instrument or any law for the time being in force, the bank, on being satisfied that it is necessary so to do in the public interest or in the interest of the depositors, may direct, the non-banking financial company against which an order prohibiting from accepting deposit has been issued, not to sell, transfer, create charge or mortgage or deal in any manner with its property and assets without prior written permission of the bank for such period not exceeding six months from the date of the order.

NBFC Prudential (Reserve Bank of India) Directions, 1988

6A. Need for Policy on Demand/Call Loans

- (1) The Board of Directors of every NBFC granting/intending to grant demand/call loans shall frame a policy for the company and implement the same.
- (2) Such policy shall, *inter alia*, stipulate the following, -
 - (i) A cut off date within which the repayment of demand or call loan shall be demanded or called up;
 - (ii) The sanctioning authority shall, record specific reasons in writing at the time of sanctioning demand or call loan, if the cut off date for demanding or calling up such loan is stipulated beyond a period of one year from the date of sanction;
 - (iii) The rate of interest which shall be payable on such loans;
 - (iv) Interest on such loans, as stipulated shall be payable either at monthly or quarterly rests;
 - (v) The sanctioning authority shall, record specific reasons in writing at the time of sanctioning demand or call loan, if no interest is stipulated or a moratorium is granted for any period;
 - (vi) A cut off date, for review of performance of the loan, not exceeding six months commencing from the date of sanction;
 - (vii) Such demand or call loans shall not be renewed unless the periodical review has shown satisfactory compliance with the terms of sanction.

Appendix XI

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

Sl. No.	Industry	Products
1.	Cement	Cement, Clinker
2.	Cycles	Cycles, component of cycles
3.	Caustic Soda,	Caustic soda in all forms
4.	Tyres & Tubes	Rubber tyres and tubes for all types of vehicles
5.	Air-Conditioners	Air conditioning system or device by which air is controlled for the fulfillment of required condition of the confined space through controlling temperature, humidity, air purity and air motion for human comforts
6.	Refrigerators	Refrigerators
7.	Batteries other than Dry Cell Batteries	Batteries of all types other than Dry Cell Batteries
8.	Electric Lamps	Electric lamps of all types
9.	Electric Fan	Any type of electric fan
10.	Electric Motors	All types of electric motors
11.	Motor Vehicles	<ol style="list-style-type: none">1. All types of passenger cars, jeeps and station wagons2. All types of commercial vehicles, delivery and pick up vans3. Motor cycles, scooters, scooterettes & mopeds4. Three-Wheeler Vehicles5. All types of tractors6. Heavy Earth Moving Equipments

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| 12. Aluminium | <ol style="list-style-type: none">1. Alumina2. Aluminium3. Aluminium ingots in any form or Alloy4. Aluminum rolled products including foil5. Aluminum extruded products6. Properzirod or Aluminum wire rod7. Any other aluminium product or its alloy |
| 13. Vanaspati | Refined vegetable oils and vegetable oil including industrial hard oil |
| 14. Bulk Drugs | Bulk Drugs under any system of medicine including Ayurvedic, Homeopathic, Siddha and Unani Systems of medicine and Intermediates thereof. |
| 15. Sugar | Sugar by vacuum pan process and excludes jaggery and Khandsari |
| 16. Industrial Alcohol | <ol style="list-style-type: none">1. Absolute Alcohol2. Rectified spirit3. Denatured and special denatured spirit4. Power alcohol |
| 17. Jute Goods | Jute goods – Yarn, Twine, Fabrics or any other product made wholly from, or containing not less than 50% by weight of, jute including bimlipattam jute or mesta fibres |
| 18. Paper | Paper-used for printing, writing and wrapping, newsprint, paperboard and exercise note books |
| 19. Rayon | <ol style="list-style-type: none">1. Viscose staple fibre in all forms2. Viscose filament yarn3. Viscose tyre yarn/cord/Fabric4. 100% Viscose Yarn Fabric5. Acetate yarn/fibre6. Rayon film (Cellophane Film) |

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20.	Dyes	Acid dyes, basic dyes, direct dyes, sulphur dyes, vat dyes, azoic dyes ingrained dyes, metal complex dyes, disperse dyes, reactive dyes oil dyes, and water soluble dyes
21.	Soda Ash	Soda Ash in all forms
22.	Polyester	<ol style="list-style-type: none"> 1. Polyester fibre 2. Polyester filament yarn 3. Polyester Chips 4. Polyester Fibre Fill (PFF) 5. Partially Oriented Yarn (POY) 6. Processed Polyester yarn (texturised, twisted, dyed, crimped, etc.) 7. 100% Polyester fabric
23.	Nylon	<ol style="list-style-type: none"> 1. Nylon chip 2. Nylon fibre 3. Nylon filament yarn 4. Nylon partially oriented yarn 5. Nylon tyre yarn or cord 6. Nylon tyre cord fabric 7. 100% Nylon fabrics
24.	Textiles	Any art silk cloth, cloth, cotton yarn or cotton cloth, processed yarn and processed cloth, man-made fibre yarn or man made fibre cloth, silk yarn or silk cloth, wool, woollen yarn or woollen cloth, yarn or other textiles products.
25.	Dry Cell Batteries	All types of dry cell batteries & Components thereof
26.	Sulphuric Acid	Sulphuric acid in the various grades-Technical (Commercial), Battery, Pure, Analytical etc.
27.	Steel Tubes and Pipes	Steel Tubes & Pipes (Including stainless steel) both black & galvanized

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| 28. Engineering | <ol style="list-style-type: none">1. Power driven pumps2. Internal combustion engines3. Diesel Engines4. All type of automotive parts and accessories5. Power Transformers6. Electric generator7. Machine tools |
| 29. Electric Cables and Conductors | <ol style="list-style-type: none">1. Power cables (All types – PILC, PVC, XLPE etc.)2. VIR/Rubber covered cables & flexible wires of all types3. PVC insulated cables, flexible wires of all types including switchboard wires & cables4. Enameled covered wires & strips5. Wire & strips covered with paper, glass, silk & any other types of insulating materials6. AAC/ACSR Conductors7. Telecommunication cables |
| 30. Bearings | Bearings of various types e.g. ball & roller bearings, needle bearing of various sizes |
| 31. Milk Food | Any type of Milk food including infant Milk complementary or supplementary food of infants and children, energy food or food drink under any brand name, derivatives of milk such as ice-cream, chocolates, desi ghee under any brand name |
| 32. Chemical | <ol style="list-style-type: none">1. Ethylene2. Ethylene Oxide3. Ethylene Glycol4. Diethylene Glycol |

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5. Polyethylene Glycol
6. Ethylene Dechloride
7. Propylene
8. Isopropanol
9. Acetone
10. Diacetone Alcohol
11. Methyl Isobutyl Ketone (MIK)
12. Butanol
13. 2 Ethyl Hexanol
14. Butadiene
15. Benzene
16. Toluene
17. Synthetic Resins & Plastics
18. Synthetic Rubber
19. Boric Acid
20. Sodium Tripoly Phosphate
21. Aluminium Fluoride
22. Calcium Carbide
23. Carbon Black
24. Titanium Dioxide
25. Acetic Acid
26. Acetic Anhydride
27. Aniline
28. Chloro Methanes

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29. Formaldehyde
30. Linear Alkyl Benzene
31. Maleic Anhydride
32. Methanol
33. Methyl Ethyl Ketone
34. Nitrobenzene
35. Ortho Nitro Chloro Benzene
36. Para Nitro Chloro Benzene
37. Polypropylene
38. Polyethylenes viz. LDPE, HDPE, LLDPE
39. Penta Erithritol
40. Phenol
41. Xylenes
33. Formulations All formulations under any system of medicine including Ayurvedic, Homeopathic, Siddha and Unani
34. Steel Plant Steel & steel products, Steel products include Ingot Steel, Blooms, Billets, Slabs (code as well as semi-finished); steel products produced by backward integration like Coal based Sponge Iron, Gas based hot briquetted Iron, steel products produced by forward integration like Beams Angles, Tees, Sees, Channels, Pilings, Rails, Crane Rails, Joint Bars, Bare (Round, Squares, Hexagonal, Octagonal, Flat, Triangular, Half Round); Wire, Wire Ropes, Nails, Wire Fabrics, Plates, Pipes and Tubes, HR Coils/Sheets, CR Coils/Sheets
35. Insecticides
 1. Insecticides
 2. Fungicides

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|----------------------------|---|
| | 3. Redenticides |
| | 4. Nematicide |
| | 5. Weedicide |
| | 6. Plant growth Regulant |
| | 7. Herbicides |
| | 8. Fumigants |
| | 9. Bio-pesticides |
| 36. Fertilizers | 1. Straight Nitrogenous Fertilizers |
| | 2. Straight Phosphatic Fertilizers |
| | 3. Straight Potassic Fertilizers |
| | 4. N.P. Fertilizers |
| | 5. N.P.K. Fertilizers |
| | 6. Micro Nutrients |
| | 7. Fortified Fertilizers |
| 37. Soaps & Detergents | Cleansing material used for washing, bathing/toilet purposes and include soaps and detergents (whether in the form of cake, powder or liquid) |
| 38. Cosmetics & Toiletries | Powders, Creams, Toothpastes, Toothpowders, Shaving Creams, After shave lotions, Shaving soaps, Shaving foams, Perfumes, Hair oils, Hair creams, Oxidation hair dyes, Mouthwash, Cologne, Shampoos-soap based, Shampoos-synthetics, detergent based, Room fresheners, Deodorants, Surfactants |
| 39. Footwear | Shoes, boots, sandals, chappals, slippers, play shoes & moccasins |
| 40. Shaving Systems | 1. Shaving blades |
| | 2. Razors |

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3. Any part or component thereof
4. Any other shaving instrument
41. Industrial Gases Oxygen, Gas, Nitrogen Gas, Acetylene Gas, Hydrogen Gas, Nitrous Oxide Gas, Argon Gas, Helium Gas, Carbon di-oxide Gas
42. Mining and Metallurgy List of products (metals and non-metals, their minerals, ores and alloys)
 1. Uranium
 2. Thorium
 3. Zirconium
 4. Titanium
 5. Lead
 6. Copper
 7. Zinc
 8. Nickel
 9. Cobalt
 10. Chromium
 11. Gallium
 12. Germanium
 13. Platinum
 14. Molybdenum
43. Electronic Products 1. All Consumer electronics such as television both black & white and colour, video cassette recorder, video cassette player, audio compact disc player, video compact disc player, digital video compact disc player, radio receiver, tape recorder & combination, electronic watch and electronic clock, etc.

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2. Industrial electronics including all control instrumentation and automation equipment.
 3. Computer including personal computer, laptop, note book, server, workstations, supercomputers, data processing equipment and Peripherals like monitors, keyboards, disk drivers, printers, digitizers, SMPs, modems, networking products and add-on cards.
 4. Communication and broad-casting equipment including cable television equipment.
 5. Strategic electronics and systems such as navigation and surveillance systems, radars, sonars, infra-red detection and ranging system, disaster management system, internal security system, etc.
 6. Other electronic component and equipment such as picture tube, printed circuit board, etc.
44. Electricity Industry
1. Generation of Electricity from-
 - (a) Thermal power,
 - (b) gas turbine,
 - (c) hydro electric power,
 - (d) atomic power,
 - (e) solar power,
 - (f) wind power,
 - (g) any other source of energy
 2. Transmission and bulk supply of electricity
 3. Distribution and retail supply of electricity
45. Plantation Products
1. Tea and tea products
 2. Coffee and coffee products

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3. Other commercial plantation products including seeds thereof.
 46. Petroleum Industry Crude oil, gases (including Liquefied natural Gas and re-gasification thereof) or any petroleum products:
 47. Telecommunication
 1. Basic telephony:
 - (a) Telephone access
 - (b) Local call
 - (c) Subscriber trunk dialing (STD)
 - (d) International subscriber dialing (ISD)
 2. Cellular Mobile;
 3. Telex;
 4. Telegraphy;
 5. Voice Mail / Audiotex service;
 6. Internet operations including gateway service/Email;
 7. Packet switched public data network (PSPDN) service;
 8. Wireless in local loop (WILL) service;
 9. Public mobile radio trunk Service;
 10. Very Small Aperture Terminal service;
 11. Global mobile personnel communication services;
 12. Leased circuits;
 13. Internet ports;
 14. National Long Distance Operator;
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15. Internet Telephony;
 16. Radio Paging;
 17. Any other telecommunication service for commercial use.
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**Prudential Norms for
Revenue Recognition and Classification of Assets
for Nidhi and Mutual Benefit Societies**

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

NOTIFICATION

New Delhi the 30th April, 2002

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

1. Every company declared as a *Nidhi* or Mutual Benefit Society under section 620A of the Companies Act, 1956 (hereinafter referred to as such *Nidhi* or Mutual Benefit Society) after the publication of this Notification shall adhere to the following prudential norms for revenue recognition and classification of assets in respect of mortgage loans or jewel loans, namely:
 - (i) income including interest or any other charges on non-performing assets shall be recognised only when it is actually realised. Any such income recognised before the asset became non-performing and remaining unrealised shall be reversed in the current year's profit and loss account;
 - (ii) classification of assets
 - (a) Mortgage Loan:

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

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Explanation: In this direction,-

- (1) "Standard Asset" means the asset in respect of which no default in repayment of principal or payment of interest is perceived and which does not disclose any problem nor carry more than normal risk attached to the business;
- (2) "Sub-Standard Asset" will be that borrowal account which is a non-performing asset. Reschedulement or Renegotiation or Replacement of the loan instalment or interest payment would not change the classification of assets unless the borrowal account has satisfactorily performed for at least 12 months after such reschedulement or renegotiation or rephasing;
- (3) "Doubtful Asset" will be that borrowal account which remained non-performing for more than two years but up to three years;
- (4) "Loss Asset" will be that borrowal account which remained non-performing for more than three years or where as per the opinion of the Nidhi or its internal auditor or by the inspecting authority during the course of its inspection a shortfall in the recovery of the loan account is expected because the documents executed may become invalid if subjected to legal process or for any other reason;
- (5) "Non-Performing Asset" will be that borrowal account where interest income and/or instalment of loan towards repayment of principal amount remained unrealised for 12 months:

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

TABLE

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

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

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

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

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

(Rajiv Mehrishi)
Joint Secretary

**Specimen Auditor's Report to the
Members of the Company**

The Members of(name of the Company)²⁰

1. We have audited the attached balance sheet of (name of the company), as at 31st March 20XX, the profit and loss account and also the {cash flow statement}²¹ for the year ended on that date annexed thereto. These financial statements are the responsibility of the company's management. Our responsibility is to express an opinion on these financial statements based on our audit.

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

3. As required by the Companies (Auditor's Report) Order, 2003²² issued by the Central Government of India in terms of sub-section (4A) of section 227 of the Companies Act, 1956, we enclose in the Annexure²³ a statement on the matters specified in paragraphs 4 and 5 of the said Order.

²⁰ Reference may also be made to the Standard on Auditing (SA) 700, "The Auditor's Report on Financial Statements", Statement on Qualifications in the Auditor's Report and the Guidance Note on Section 227(3)(e) and (f) of the Companies Act, 1956, issued by the Institute of Chartered Accountants of India.

²¹ Wherever applicable.

²² All references made in this Specimen Auditor's Report to Companies (Auditor's Report) Order, 2003 should be construed as being to the Companies (Auditor's Report) Order, 2003 as amended by Companies (Auditor's Report) (Amendment) Order, 2004.

²³ Alternatively, instead of giving the comments on Companies (Auditor's Report) Order, 2003 in an Annexure, the comments may be contained in the body of the main report.

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

- (i) We have obtained all the information and explanations, which to the best of our knowledge and belief were necessary for the purposes of our audit;
- (ii) In our opinion, proper books of account as required by law have been kept by the company so far as appears from our examination of those books (and proper returns adequate for the purposes of our audit have been received from the branches not visited by us. The Branch Auditor's Report(s) have been forwarded to us and have been appropriately dealt with)²⁴;
- (iii) The balance sheet, profit and loss account and {cash flow statement}²⁵ dealt with by this report are in agreement with the books of account (and with the audited returns from the branches)²⁶;
- (iv) In our opinion, the balance sheet, profit and loss account and {cash flow statement}²⁷ dealt with by this report comply with the accounting standards referred to in sub-section (3C) of section 211 of the Companies Act, 1956;
- (v) On the basis of written representations received from the directors, as on 31st March 20XX and taken on record by the Board of Directors, we report that none of the directors is disqualified as on 31st March 20XX from being appointed as a director in terms of clause (g) of sub-section (1) of section 274 of the Companies Act, 1956;
- (vi) In our opinion and to the best of our information and according to the explanations given to us, the said accounts give the information required by the Companies Act, 1956, in the manner so required and give a true and fair view in conformity with the accounting principles generally accepted in India:
 - (a) in the case of the balance sheet, of the state of affairs of the company as at 31st March 20XX;
 - (b) in the case of the profit and loss account, of the profit/loss²⁸ for the year ended on that date; and

²⁴ Wherever applicable.

²⁵ Wherever applicable.

²⁶ Wherever applicable.

²⁷ Wherever applicable.

²⁸ Whichever is applicable.

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- (c) {in the case of the cash flow statement, of the cash flows for the year ended on that date.}²⁹

For ABC and Co.
Chartered Accountants

Signature

(Name of the Member Signing the Audit Report)

(Designation)³⁰

Membership Number

Place of Signature

Date

²⁹ Wherever applicable.

³⁰ Partner or proprietor, as the case may be.

Re:.....Limited

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

- (i) (a) The company has maintained proper records showing full particulars including quantitative details and situation of fixed assets.
- (b) All the assets have not been physically verified by the management during the year but there is a regular programme of verification which, in our opinion, is reasonable having regard to the size of the company and the nature of its assets. No material discrepancies were noticed on such verification.
- (c) During the year, the company has disposed off a substantial part of the plant and machinery. According to the information and explanations given to us, we are of the opinion that the sale of the said part of plant and machinery has not affected the going concern status of the company.
- (ii) (a) The inventory has been physically verified during the year by the management. In our opinion, the frequency of verification is reasonable.
- (b) The procedures of physical verification of inventories followed by the management are reasonable and adequate in relation to the size of the company and the nature of its business.
- (c) The company is maintaining proper records of inventory. The discrepancies noticed on verification between the physical stocks and the book records were not material.
- (iii) (a) The company has granted loan to two companies covered in the register maintained under section 301 of the Companies Act, 1956. The maximum amount involved during the year was Rs.20 crores and the year-end balance of loans granted to such parties was Rs. 20 crores.
- (b) In our opinion, the rate of interest and other terms and conditions of such loans are not, *prima facie*, prejudicial to the interest of the company.
- (c) The parties have repaid the principal amounts as stipulated and have also been regular in the payment of interest to the company.

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- (d) There is no overdue amount in excess of Rs. 1 lakh in respect of loans granted to companies, firms or other parties listed in the register maintained under section 301 of the Companies Act, 1956.
- (e) The company had taken loan from five companies covered in the register maintained under section 301 of the Companies Act, 1956. The maximum amount involved during the year was Rs.50 crores and the year-end balance of loans taken from such parties was Rs. NIL.
- (f) In our opinion, the rate of interest and other terms and conditions on which loans have been taken from companies, firms or other parties listed in the register maintained under section 301 of the Companies Act, 1956 are not, *prima facie*, prejudicial to the interest of the company.
- (g) The company is regular in repaying the principal amounts as stipulated and has been regular in the payment of interest.
- (iv) In our opinion and according to the information and explanations given to us, there exists an adequate internal control system commensurate with the size of the company and the nature of its business with regard to purchases of inventory, fixed assets and with regard to the sale of goods and services. During the course of our audit, we have not observed any continuing failure to correct major weaknesses in internal control system of the company.
- (v)
 - (a) According to the information and explanations given to us, we are of the opinion that the particulars of all contracts or arrangements that need to be entered into the register maintained under section 301 of the Companies Act, 1956 have been so entered.
 - (b) In our opinion and according to the information and explanations given to us, the transactions made in pursuance of contracts or arrangements entered in the register maintained under section 301 of the Companies Act, 1956 and exceeding the value of rupees five lakhs in respect of any party during the year have been made at prices which are reasonable having regard to prevailing market prices at the relevant time.
- (vi) In our opinion and according to the information and explanations given to us, the company has complied with the provisions of sections 58A and 58AA and other relevant provisions of the Companies Act, 1956 and the Companies (Acceptance of Deposits) Rules, 1975 with regard to the

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deposits accepted from the public. No order has been passed by the Company Law Board or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal.

- (vii) In our opinion, the company has an internal audit system commensurate with the size and nature of its business.
- (viii) We have broadly reviewed the books of account relating to materials, labour and other items of cost maintained by the company pursuant to the Rules made by the Central Government for the maintenance of cost records under section 209 (1) (d) of the Companies Act, 1956 and we are of the opinion that *prima facie* the prescribed accounts and records have been made and maintained.
- (ix) (a) The company is regular in depositing with appropriate authorities undisputed statutory dues including provident fund, investor education protection fund, employees' state insurance, income tax, sales tax, wealth tax, service tax, custom duty, excise duty and other material statutory dues applicable to it.

Further, since the Central Government has till date not prescribed the amount of cess payable under section 441A of the Companies Act, 1956, we are not in a position to comment upon the regularity or otherwise of the company in depositing the same.

(b) According to the information and explanations given to us, no undisputed amounts payable in respect of income tax, sales tax, wealth tax, service tax, customs duty and excise duty were in arrears, as at..... for a period of more than six months from the date they became payable.

(c) According to the information and explanation given to us, there are no dues of income tax, sales tax, wealth tax, service tax, customs duty and excise duty which have not been deposited on account of any dispute.
- (x) In our opinion, the accumulated losses of the company are not more than fifty percent of its net worth. Further, the company has not incurred cash losses during the financial year covered by our audit and the immediately preceding financial year.
- (xi) In our opinion and according to the information and explanations given to us, the company has not defaulted in repayment of dues to a financial institution, bank or debenture holders.

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- (xii) We are of the opinion that the company has maintained adequate records where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities.
- (xiii) In our opinion, the company is not a chit fund or a *nidhi*/mutual benefit fund/society. Therefore, the provisions of clause 4(xiii) of the Companies (Auditor's Report) Order, 2003 are not applicable to the company.
- (xiv) In our opinion, the company is not dealing in or trading in shares, securities, debentures and other investments. Accordingly, the provisions of clause 4(xiv) of the Companies (Auditor's Report) Order, 2003 are not applicable to the company.
- (xv) In our opinion, the terms and conditions on which the company has given guarantees for loans taken by others from banks or financial institutions are not prejudicial to the interest of the company.
- (xvi) In our opinion, the term loans have been applied for the purpose for which they were raised.
- (xvii) According to the information and explanations given to us and on an overall examination of the balance sheet of the company, we report that the no funds raised on short-term basis have been used for long-term investment.
- (xviii) According to the information and explanations given to us, the company has made preferential allotment of shares to parties and companies covered in the register maintained under section 301 of the Act. In our opinion, the price at which shares have been issued is not prejudicial to the interest of the company.
- (xix) According to the information and explanations given to us, during the period covered by our audit report, the company had issued 1,00,000 debentures of Rs. 100 each. The company has created security in respect of debentures issued.
- (xx) We have verified the end use of money raised by public issues from the draft prospectus filed with SEBI, the offer document and as disclosed in the notes to the financial statements.
- (xxi) According to the information and explanations given to us, no fraud on or by the company has been noticed or reported during the course of our audit.

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For ABC and Co.,
Chartered Accountants
Signature
(Name of the Member Signing the Audit Report)
(Designation)³¹
Membership Number

Place of Signature

Date

³¹ Partner or Proprietor, as the case may be.