What will we learn today?

► Clauses of CARO 2003

► Issues on CARO
CARO 2003 – The ‘Basics’
Overview

► Governing Law - ‘The Companies Act, 1956’ (‘Act’)

► Applicability of CARO 2003 –
  • CARO is applicable to all companies including foreign companies
  • CARO is also applicable to Branch(es) of company

Following company are exempted from CARO

• Banking, Insurance and Section 25 companies

• A private limited company:
  • With a paid up capital and reserves of less than Rs 50 lacs
  • Does not have any loans outstanding more than Rs 25 lacs from any banks or Financial Institutions
  • Does not have turnover exceeding Rs 5 crores
## CARO 2003

### Applicability issues

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CARO 2003 – The ‘Basics’
Applicability

Issue:
Whether CARO is applicable to companies covered by section 4(7) of the Companies Act?

Response:
CARO is not applicable to a private limited company with a paid-up capital and reserves of not more than rupees fifty lakhs 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. Thus a private limited company, in order to be exempt from the applicability of the Order, must satisfy all the conditions mentioned above cumulatively.

A section 4(7) company is deemed to be a subsidiary of a public company. CARO would be applicable to section 4(7) company that otherwise fulfills the non-applicability criteria applicable to a private company. Hence CARO would apply to all section 4(7) companies.
CARO 2003 – The ‘Basics’
Applicability

Issue:
Whether CARO is applicable to Liaison Offices (LOs)?

Response:
The Companies (Auditor’s Report) Order, 2003 (CARO) contains the following provision in respect of its applicability: "It shall apply to every company including a foreign company as defined in section 591 of the Act ". As can be noticed, activities of the company specified in MAOCARO are not specified in CARO. The exemption of reporting under MAOCARO in respect of LOs was due to the reason that LO was not engaged in the specified activities of MAOCARO. Since CARO is applicable to all foreign companies irrespective of their activity, CARO applies to the LOs of the foreign companies.

Further, all the clauses have to be reported on and not merely the applicable clauses as has been clarified in the ICAI statement.
CARO 2003 – The ‘Basics’
Applicability

Issue:
Whether CARO is applicable to a private limited company which has accepted inter-corporate deposits?

Response:
Inter-corporate deposits are excluded from the meaning of deposit as per rule 2(b) of the Companies (Acceptance of Deposit) Rules, 1975. Therefore CARO is not applicable if the private limited company also satisfies other conditions for exemptions from the applicability of CARO.
CARO 2003 – The ‘Basics’
Applicability

Issue:
Co-Co Investment Private Limited Company, has paid-up capital and reserves not more than rupees fifty lakhs and has not accepted any public deposit and does not have outstanding loan exceeding rupees twenty-five lakhs from any bank or financial institution. Co-Co makes investment and earns dividend and interest income of Rs 575 lakhs approximately. Whether CARO is applicable to Co-Co?

Response:
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.

In the given case, CARO would be applicable to Co-Co because its turnover is more than Rs 5 crores. The income received by way of dividend/interest would form part of “turnover” since the principal business of Co-Co is investment. If the principal business of Co-Co was not investment, the interest/dividend income would not have formed part of turnover but would have formed part of other income. Had that been the case, CARO would not have become applicable to Co-Co.
CARO 2003 – The ‘Basics’
Applicability

Issue:
Co-Co Investment Private Limited Company, has paid-up capital and reserves not more than rupees fifty lakhs and has not accepted any public deposit and has an outstanding loan of rupees twenty-four lakhs from a bank at the end of the year. The maximum outstanding during the year was rupees twenty-six lakhs. Co-Co has maintained a fixed deposit of Rs 2 lakhs throughout the year with the bank as a security. Co-Co makes investment and earns dividend and interest income of Rs 475 lakhs approximately. Whether CARO is applicable to Co-Co?

Response:
CARO would be applicable to Co-Co, since during the year the loan exceeded Rs 25 lakhs. The fact that Co-Co has maintained a fixed deposit as security against the loan is irrelevant. In other words, the loan amount will not be reduced by the fixed deposit amount for determining the applicability of CARO.
CARO 2003 – The ‘Basics’
Applicability

Issue:
Jo-Jo Private Ltd has accounting year 1 April to 31 March. From April 1 to 30 March the turnover is Rs 540 lakhs. On 31st March goods worth Rs 45 lakhs are returned. Whether CARO is applicable to Jo-Jo?

Response:
Though the annual turnover is less than Rs 5 crores, turnover during the year exceeded Rs 5 crores. Thus, CARO is applicable to Jo-Jo.
**Issue:**
For purpose of determining CARO applicability to a private limited company, in respect of the loan outstanding of Rs 25 lakhs or more, whether:

a) bank guarantees issued by a bank would be counted as loan?
b) outstanding amount as per bank statement or as per company’s book should be considered?
c) loans from private banks/foreign banks should be considered?
d) short-term loans are included?
e) corporate credit card outstanding would be considered?

**Response:**

a) In case bank guarantees issued by the company have been invoked or devolved on the company, the amount of guarantee should be included in the amount of loan outstanding. If bank guarantees have not been invoked or devolved, the amount of guarantee should not be included in the loan outstanding.

b) The figures as appearing in the books of account of the company after taking into account the particulars of amounts appearing in the reconciliation statements should be considered.

c) All banks under the Banking Regulation Act would be considered which includes private banks and foreign banks.

d) Both short-term and long-term loans are included.

e) Yes, corporate credit card outstanding would be included.
CARO 2003 – The ‘Basics’
Applicability

**Issue:**
Under a sales tax deferral scheme, Jo-Jo Private Ltd has converted sales tax liability of Rs 30 lakhs into a loan. Is CARO applicable to Jo-Jo?

**Response:**
The said loan is not covered by the definition of loan from a bank or financial institution. Therefore, CARO is not applicable to Jo-Jo provided other conditions for availing the exemption are satisfied.
Issue:
When particular clauses are not applicable, in some cases the practice is to either (a) state so in one clause (aggregate reporting) (b) state so for each of the reporting clause (individual reporting) (c) sometimes no reporting of non applicability is done.

Response:
Statement on CARO states “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”
Issue:
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. Whether the auditor's comments in terms of the Order form part of his report and whether the board will be bound to give in its report the fullest information and explanations regarding every adverse comment therein?

Response:
Yes. 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.
Issue:
What are the reporting responsibilities of the auditor as well as the disclosure requirements in case of a private limited company to which the Order is not applicable?

Response:
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 (as amended), 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."
CARO 2003 – The ‘Basics’
Reporting

Issue:
What are the reporting responsibilities of the auditor of a branch of a private limited company under the Order in case such a branch fulfills the conditions for exemption from the applicability of the Order?

Response:
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.
Clause (i) (a) : Fixed Assets - Maintenance of proper records of fixed assets showing full particulars including quantitative details.

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;
Clause wise listing

Clause (i) (a) : Fixed Assets

(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 amortization, as the case may be;

(x) depreciation/amortization for the current year;

(xi) accumulated depreciation/amortization;

(xii) particulars regarding impairment;

(xiii) particulars regarding sale, discarding, demolition, destruction, etc.
Clause (i) (b): Fixed Assets - 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;

- Physical verification (PV) responsibility of Management. Auditor should satisfy that such a verification was done and there is adequate evidence that supports that conclusion.

- 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. Rotational PV is allowed (at least once in 3 years), however the fact that the assets are not verified in the current year should be reported by the auditor. Also, if the auditor is satisfied with the frequency suitable comment should be made in the report.
Clause wise listing

Clause (i) (c) : Fixed Assets - If substantial part of fixed assets have been disposed off, whether it has affected ‘going concern’.

- **Issues**
  - What is the meaning of “substantial”
  - How to determine impact on going concern

- **Comments**
  Order does not define the word “substantial” Primarily depends upon facts and circumstances of each case. A substantial sale should not affect entities ability to continue in operation for foreseeable future.
  Link with requirements of SA 570 “Going Concern”.

There maybe cases where Going concern is an issue but no FA disposal. Sometimes GC issues could lead to significant FA disposal.
…Fixed Assets…

- **Special situations**
  - Assets taken on finance lease
  - Assets held for disposal
  - Impaired assets
  - Jointly owned assets

- **Physical verification**
  - Use of experts
  - Assets at multiple locations
  - Movable assets like vehicles, rolling stock, etc.
CARO 2003 – The ‘Basics’
Clause wise listing

► Clause (ii) : Inventories

(a) Physical verification of inventory at reasonable intervals

(b) Are physical verification procedures reasonable and adequate? Report deficiencies

(c) Are proper records of inventory maintained and whether material discrepancies noticed on physical verification are properly dealt with in the books of accounts.

► Issues

✓ Periodic Vs Continuous Verification

✓ What do you mean by “Proper Records”
Clause (ii) : Inventories – Key points

- Physical verification responsibility of management. Auditor should satisfy that the management conducts the verification at regular intervals.

- “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 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.

- Auditor to make use of his professional judgment to establish the reasonableness and adequacy of procedures adopted for physical verification of inventories.
Query:
AS-2 does not apply to valuation of work-in-progress of a construction company. Therefore, would this CARO clause apply to construction companies?

Response
Yes. Work-in-progress of construction companies is valued in accordance with AS-7 and not AS-2. However, the definition of inventories under AS-2 includes work-in-progress though valuation of construction work-in-progress is excluded from AS-2 scope. The need for a specific exclusion of construction work-in-progress arose because it fell within the definition of inventories under AS-2.
Query:
For purpose of reporting under this clause, can the auditor rely on the work of the internal auditor?

Response
The statutory auditor should form his own opinion, based on various audit procedures, including relying on the work of the internal auditor. The auditor should not blindly rely on the work of the internal auditor and in any case that should not be the sole audit procedure. He should ensure compliance with AAS-7, “Relying Upon the Work of an Internal Auditor”. Though the auditor can rely on the work of an internal auditor if circumstances so permit and in accordance with AAS-7, for specific CARO reporting he must carry out certain additional procedures by himself. For example, the auditor may complete an illustrative list of questions for evaluating internal controls.
Query:
Companies do not maintain inventory records or registers in respect of work-in-progress. In such situations, what is the manner of reporting by the auditor?

Response
A question generally arises as to what constitutes proper record in the context of work-in-progress. A lot of companies do not use an integrated accounting package and even those who use such packages do not have an inventory tracking system. Consequently, book records in respect of work-in-progress are not available on line. It is understood that in many cases it is impracticable to maintain physical record for work-in-progress. In such a case, 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. If the company is able to do so, the auditor may form an opinion that proper records relating to work-in-progress have been kept. 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.
Clause (iii) : Loans relating to 301 parties

a) Reporting on loans granted to parties listed in Section 301 register, along with number of parties and amount involved

b) Whether rate of interest and other terms and conditions are prima facie prejudicial to the interest of the company

c) Whether the receipt of principal amount and interest are also regular

d) Whether reasonable steps taken in case overdue amount is more than Rs. 1 lac

e) Reporting on loans taken from section 301 parties with number of parties and amount involved

f) Whether rate of interest and other terms and conditions are prima facie prejudicial to the interest of the company

g) Whether the payment of principal amount and interest are also regular

h) Linkage of requirements of clause 227 (1A) with this clause.
CARO 2003 – The ‘Basics’
Clause wise listing

► Clause (iii) : Issues Loans relating to 301 parties

✓ How to ensure completeness of entries in Section 301 register

✓ Do we need to report transactions squared off during the year?

✓ How to determine whether reasonable steps have been taken for recovery /payment of principal and interest?
Query:
If a loan is given to an employee of the company, who is also a relative of the director of the company, can it be covered for reporting under this clause?

Response
Yes. Section 301 register covers all section 297 and 299 items. Under section 297, board approval is required including in the case of a relative of a director for the sale, purchase or supply of any goods, material or services. Since the employee is providing services to the company, he is a party covered in the section 301 register.

***
Query:
Are loans given/taken (a) at such time when particulars were required to be entered in the section 301 register (b) prior to party becoming a section 301 party during the year (party became a 301 party later during the year) (c) after party is no longer a section 301 party covered for reporting under this clause?

Response
In the case of (a) and (b) reporting is required since during the year when the party was a 301 party, monies remained outstanding from that party. The point of time at which the loan was granted, therefore, is not important. If the loans were given/taken during the year but squared off before the party became a 301 party, reporting would not be required.

In the case of (c), the auditor’s comments are not required, since the parties to whom loans were given/taken ceased to be 301 parties.
Query:
How will the auditor report under this clause, when the company has either not maintained or updated the section 301 register and the necessary declarations from directors in Form 24AA are also not available on record?

Response
The auditor should mention that fact in his report. Where Form 24AA declarations were filed or it is possible to identify (not comprehensively) by some other means the section 301 parties, the auditor should comment on the loans given/taken in respect of the parties so identified. However the auditor should add his reservation that, section 301 parties are not identified comprehensively by the management and hence the auditors comment is not comprehensive.
Query:
Two group companies with common directors borrow and lend frequently to each other without a loan agreement or a repayment schedule. What are the requirements of section 301 and how would the auditor report on such loans in either of the company?

Response
Since there are common directors in the two companies, section 299 would apply if any of the directors of the one company or two or more of them together hold 2% of the paid up share capital of the other company. The auditor should consider all relevant facts and circumstances including that there is no loan agreement or repayment schedule and use his professional judgement to conclude if the terms and conditions of the loan are prejudicial or not. Merely because there is no loan agreement or a repayment schedule would not tantamount to the loan being prejudicial to the interest of the company.
Query:
How will the auditor report under this clause, where loan is repayable on demand?

Response
A loan repayable on demand falls due when the lender makes a demand. If the lender has not demanded the loan, the auditor should state that fact and report that comment on payment of principal amount cannot be made, since the terms of repayment are not stipulated. If the lender has made a demand, the auditor should comment on the regularity of payment of principal amount based on the demand.
Clause (iv): Adequacy of internal control

Adequacy of internal control over purchase of inventory and fixed assets and sale of goods and services. Whether there is continuing failure to correct major weaknesses in internal control system.

Issues:

✓ When is internal control adequate?
✓ Reporting under this clause if no test of controls have been carried out?
✓ Can we report on this clause without testing Internal controls? If not, then how much to test?
Clause (iv): Adequacy of internal control

Key points:

- Different techniques may be used to document information relating to internal control systems like narrative descriptions, flow charts, questionnaires, checklist etc.

- Irrespective of the method selected, it is necessary that the auditor maintains sufficient documentation regarding his study and evaluation of the internal control system.

- Auditor to use professional judgment to evaluate material weakness.

- 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.

- The requirements in regard to adequacy of internal controls and continuing failure to correct major weakness(es) are not inter related. 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.
Query:
The clause requires reporting on (a) adequacy of internal control, and (b) continuing failure to correct a major weakness. Based on the audit procedures, if the auditor concludes that there are no major weaknesses, can he conclude that internal controls are adequate?

Response
One of the aspects to be borne in mind when deciding on whether the internal control system is adequate is the existence of major weaknesses. However, that does not mean, if there are no major weaknesses the internal control system is adequate. There could be a situation where the internal control system does not have a major weakness but has several small defects which when judged in totality would result in a conclusion that the internal control system is not adequate. Thus the two requirements should be looked at as distinct aspect of this clause.
Query:

Is there a “continuing failure” in the following cases:

- The weakness was identified and reported to management by the auditor in the previous year and continues to exist in the current year

- At the audit planning stage, at the beginning of the year, based on discussion, the auditor intimated to the client certain major weaknesses in internal control. This weaknesses remain uncorrected when the audit report was issued after the end of the year.

- The auditor identified and intimated to management the major weakness just a month before signing the audit report.

Response

The auditor should take the decision based on facts and circumstances of each case.

- This will constitute a continuing failure.

- This will constitute a continuing failure, since management had sufficient time to correct the failure

- This will not constitute a continuing failure
Clause (v): Contracts with Section 301 parties

a) Whether contracts / arrangement that need to be entered in section 301 register have been so entered

b) Whether such transactions* are made at prices that are reasonable having regard to the prevailing market prices at relevant time
   * where transaction value per party exceeds Rs. 5 lacs

Key Points:

✓ Perform procedures to ensure completeness of contracts/arrangements that need to be entered in 301 register have been so entered.

Some cases where 301 register not updated:

• consider other reporting obligations;
• obtain reasons why their names were not included in the register

✓ Obtain written representations from management concerning the completeness.
Query:
An auditor whilst examining the compliance with this clause finds out that the company has not obtained Central Government approval as required by section 297 of the Companies Act. How is this reflected by the auditor in the main audit report and CARO report?

Response
The auditor should mention the fact in the CARO report. The main audit report need not be qualified if adequate disclosures are made by management in the notes to account and necessary provision to meet the cost of non-compliance has been made in the financial statements.

Query:
A company makes a purchase of Rs 5,10,000 from a 301 party and in the same year gets a trade discount of Rs 20,000. Whether reporting is required under this clause?

Response
Yes, since the Rs 5 lakh limit was exceeded during the year
Query:
A company invites quotes for its purchases but does not necessarily award the contract to the lowest bidder since it gives importance to other factors such as reliability, comfort level, delivery time, quality, etc. Would the auditor need to qualify CARO?

Response
The intention of the clause is not to require the auditor to report whether the company has transacted with the parties at the lowest possible price. The reasonableness of price cannot be detached from factors such as comfort level, reliability, delivery time, quality, etc. Under the circumstances the auditor should not qualify CARO.
Key Points:

✓ 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”.

✓ Perform procedures to satisfy, 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.
Clause (vi): Public Deposits

Whether provisions of Sections 58A, 58AA or any other relevant provisions of the Companies Act, 1956 have been complied with. If not, nature of contraventions should be stated. Compliance of Company Law Board Order, if any, has to be reported.

Clause (vii): Adequacy of internal audit system

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.
Clause (vii): Adequacy of internal audit system – Key Points

✓ Mandatory for listed companies

✓ For non listed companies paid up capital and reserves and turnover criteria as specified in the previous slide will apply.

✓ A non listed company may be covered by this clause on the turnover criterion in one year and may not be so covered in another year.

✓ A company may either have its own internal audit department or entrust the work of internal audit to an outside agency or group IA team.

✓ Some factors to be considered by auditors are as follows:
  i. Size of internal audit (IA) department
  ii. Qualifications of people in the IA department
  iii. To whom does the IA report and what kinds of report are submitted.
  iv. Areas covered by the IA
  v. Follow up on the findings of the IA
Clause (viii): Cost records

Where maintenance of cost records are prescribed, whether such accounts and records have been made and maintained? If not maintained link to Section 209 requirements on maintenance of proper books of accounts.

Clause (ix): Statutory Dues

(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) if dues of sales tax, income tax, customs duty, wealth tax, excise duty, cess is not deposited on account of any dispute, the amounts involved and the forum where dispute is pending shall be mentioned

(c) 9 (b) does not cover “other statutory dues” as required under clause 9 (a)
The Delhi High Court in the case of Home Solutions had held that renting of immovable property by itself is not a service and accordingly levy of service tax through a circular/notification on the activity of renting is ultra vires the Finance Act, 1994. However, in light of the amendment in the proposed Finance Act itself (which has a retrospective effect from 1 June 2007), a provision for the service tax would be required. Whether the lessor or lessee should provide for the same is dependant on the agreement between them.

In the case of a lessor, the said provision would also be covered under clause 4(ix)(a) of CARO (depositing of undisputed statutory dues), when the bill becomes an Act. However, with regards to making the provision itself, the provision should be made nevertheless (as suggested in the previous paragraph) in anticipation of the bill becoming an Act.

Where any party continues to dispute the service tax in a court of law, despite the amendment to the Finance Act, a provision would nevertheless be required but the CARO clause that would apply would be paragraph 4(ix)(b) [disputed dues not deposited]
CARO 2003 – The ‘Basics’
Clause wise listing

▶ Issue on Clause (ix): Statutory Dues – Procedures to be performed

(a) Obtain an understanding of all statutory dues applicable to the Company along with the due dates by which the same need to be deposited with the relevant authority. Due dates will be different under various regulations and would be different from those used for IT claim purposes.

(b) Obtain a statement from the company showing the following details for the period covered under audit for statutory dues:

   i. The date on which recovery has been made and the date on which the company’s contribution or payment there against, became due,

   ii. Date of deposit

   iii. Due date applicable for that statutory payment

(c) Verify the supporting documentation for the charge and the deposit.

(d) If any delay is noticed, ascertain whether generally the deposits have been regular?

(e) Obtain Management representation.
Issue on Clause (ix): Statutory Dues

- Are all statutory dues covered?

- Does interest and penalty covered under scope of statutory dues?

- Does issue of show cause notice by the department be construed as demand?
Query:

Does this clause envisage reporting in respect of payments to approved funds, eg, approved PF fund or approved gratuity fund or superannuation fund (approved by income-tax authorities), etc?

Response

Provident fund dues are considered. However, gratuity and superannuation fund should not be treated as an authority and similarly, such dues cannot be considered as Statutory dues for CARO reporting. This is primarily because of the fact that while Provident Fund is required to be deposited on a monthly basis as per the Provident Fund Act itself, there is no such requirement for Gratuity and Superannuation contribution, whose funding is done mainly for tax benefit.
Query:

What is meant by “statutory dues”?

Response

Any sum, which is to be regularly paid to an appropriate authority under a statute (whether Central, State or Local) is a statutory due for reporting under this clause. Thus it can be inferred that meaning of the word “statutory dues” will not include International statutes.
Query:
Are the following payments covered under this clause
a) Bonus payable under the Payment of Bonus Act
b) Turnover fees payable to SEBI by brokers
c) APMC charges
d) Service tax
e) Penalty/Interest on Service tax
f) Gratuity liability under the Payment of Gratuity Act not funded by the Company
g) Tax and cess collected by State Governments through electricity bills?

Response
Yes in respect of (b), (d), (e) and (g)
No in respect of (a), (c) and (f)
Query:
The company does not pay the service tax charged in the invoice by its transporters. How will the auditor deal with this in the audit report?

Response
The liability of collecting and paying service tax is that of the transporter and not of the company. Therefore there are no CARO reporting requirements under the circumstances. However, the auditor must ensure that adequate provision is made by the company for service tax, if the company is liable to pay to the transporter and waiver is not expected from the transporter. Else, the auditor may have to qualify the main audit report, if the amounts involved are material.
Query:
A company imported certain materials five years ago under a bond but has not cleared them. Custom duty is not paid/provided for but interest and rent liability is being provided. How will the auditor report this under CARO?

Response
When imported goods are lodged in a bonded warehouse, the payment of custom duty is made when the goods are removed from the bonded warehouse. Since custom duty is not due at the present moment, the question of regularity does not arise. However, interest and rent would be incurred under section 61 of the Customs Act and would fall under statutory dues. The auditor in the CARO report will have to comment in respect of interest and rent.
Query:
Does non-payment of advance income tax constitute default in payment of statutory dues?

Response
Yes, however, the auditor is not required to ensure that the advance tax amount was correctly determined or not. A company might not have any taxable income at 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 section 234 of the Income Tax Act, it should not be construed that the company is not regular in depositing advance tax.
Query:
What is the auditor’s reporting responsibility where TDS is not deducted and not recognised in the books?

Response
The auditor is required to ascertain whether the company is required to deduct tax on certain items and whether it is regular in paying the TDS. The auditor is not required to ascertain if the tax has been properly determined or properly deducted. For example, in the case of TDS on employee’s salaries, the auditor would have to examine if the TDS has been deducted and was paid on time after it was deducted and is not concerned with whether the TDS amount was properly determined in the first place.
Query:
What is meant by “disputed dues”? Does it include a show cause notice?

Response
Cases where there exists difference of opinion between the relevant department and the company would be considered as disputed dues. It is clarified that issuance of show cause notice by the concerned department should not be construed as demand payable by the company. A show cause notice generally contains the requirements/queries of the assessing officer. Normally it does not create a statutory due. However in some cases, a show cause notice and demand may be combined in one document. Hence it would be necessary to evaluate each situation individually.
CARO 2003 – The ‘Basics’
Clause wise listing

Query:
For giving the details of the disputed statutory dues, whether aggregation can be done by period and type of Act?

Response
Yes, aggregation can be done both by period and type of Act.

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Query:
Whether immaterial amounts are required to be reported under this clause? If yes, can they be clubbed and reported in one line?

Response
Even minor amounts are required to be reported. They should be reported in a manner that the reader is able to understand the dispute and the amount involved therein.
CARO 2003 – The ‘Basics’
Clause wise listing

Query:
An amount may be disputed and not deposited with the relevant department; however, based on likely outcome a provision is made in the books. Are these amounts required to be reported?

Response
Yes. Creation of a provision in the books is irrelevant for the purposes of reporting under this clause. What is important is whether the disputed amounts are deposited or not.

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Query:
An amount is disputed but deposited with the relevant department; and based on likely outcome a recoverable amount is disclosed in the books. Are these amounts required to be reported?

Response
No. Such an amount is not contemplated for reporting since it has been deposited
Query:

Should such statutory dues, the demands of which have been set aside/referred for reassessment/stayed be disclosed or will a statement clarifying that the disclosure excludes the disputes which have been stayed/remanded, along with the aggregate amount, suffice?

Response

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 asseesee 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.
Query:

What are the reporting responsibilities of the auditor under this clause in a situation where the amount under the dispute is pending for an appeal and the time-limit for filing the appeal has lapsed?

Response

In such a case, the disputed amount would become a statutory due and the reporting responsibilities that are applicable to other statutory dues would become applicable.
Clause (x): Accumulated and cash losses.

For a company registered for not less than 5 years, whether accumulated losses exceed 50% of the net worth and whether it has incurred cash losses in current year and immediately preceding financial year.

Possible linkage to going concern issue and EOM/qualification.

Some Definitions:
(i) ‘Cash Loss’ means loss as shown by the P&L account after adjusting for effects of transactions of a non-cash nature such as depreciation, amortization, deferred tax expenses etc.. Loss should be construed as net loss after taking into account the auditor’s qualifications.

(ii) ‘Net worth’ is the sum total of the paid up capital and free reserves excluding accumulated losses. It should be determined after deducting revaluation and other similar type of reserves that are not collected in cash.

(iii) ‘Free reserves’ means all the reserves credited out of the profits and share premium account but does not include reserves credited out of revaluation of assets, write back of depreciation provisions and amalgamation

(iv) For the purpose of reporting under this clause, consider the effect of the qualifications contained in the audit report for computing the figure of losses. Where any of the qualifications is not capable of being quantified, state that the effect of such unquantified qualification(s) has not been taken into consideration.
Query:

What are the reporting responsibilities of the auditor under this clause in case the company does not have cash losses in both the years (that is, the current financial year and the preceding financial year) but only in one of these years? Should the auditor report separately for both the years or should his opinion state that the company has not incurred cash losses in two consecutive years?

Response

A prudent interpretation would be 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 year 2002-2003 i.e. the year preceding the current financial year but has not incurred any cash loss during the current financial year (2003-04).
Clause (xi): Dues to bank, finance intermediaries etc

Whether the company has defaulted in repayment of dues to a Financial Institution, Bank or Debenture holders. If yes, then the period and amount of default has to be reported.

Issues:
✓ Does default in payments covers delay in payment?
✓ What are implications of restructuring schemes?
✓ Whether the defaults committed in previous years and continuing until the year end would also be covered?

Key points:

i. Dues to financial institutions would include both principal and interest payments.
ii. Auditor to obtain schedule of repayments from management along with the due dates and verify it with the supporting agreements/documents.
iii. In case of disputes between the Company and lender on issues relating to repayment, auditor should give a disclaimer while reporting under this clause.
iv. Possible cash flow and going concern issues if there are large or frequent delays.
Clause (xii): Loan against pledge of shares

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.

Key points:

(i) This requirement is confined to loans and advances which are secured by way of pledge of shares, debentures and other securities, and does not extend to other forms of security, e.g., hypothecation, guarantee, etc.

(ii) 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.

(iii) What records would be considered adequate depends upon the nature of the security and the party to whom the loan or advance is granted.
Clause (xiii): Chit fund, Nidhi
Whether the provisions of any special statute applicable to chit fund have been duly complied with? Additional reporting requirements of nidhi/ mutual benefit fund/societies.

Clause (xiv): Companies dealing in shares
In case of companies dealing or trading in shares, etc. whether proper records have been maintained and timely entries made therein. Whether shares, etc. are held in own name, except to the extent permitted u/s 49.

Issues:
✓ Whether applies to all companies
To deal or trade implies a purchase or sale with a view to make short term profit. 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).

Reporting under this clause will be triggered if any company deals or trade in shares. Reporting is not restricted for investment companies only. If manufacturing companies have active treasury operation wherein they indulge in trading of securities frequently, reporting will be required in CARO.
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Clause wise listing

► **Clause (xv): Guarantee on loans taken by others**
Whether the terms and conditions are prejudicial in case of guarantees given by the company on behalf of others borrowings from banks and financial institutions

► **Clause (xvi): Utilisation of term loans**
Whether term loans were applied for the purpose for which loans were obtained

► **Clause (xvii): Utilisation of funds**
Whether funds raised on short term basis have been used for long term investments

**Issues:**

✓ What is a term loan?
✓ How do we establish that term loan has been used only for the stated purpose?
✓ What is definition of fund raised on short term/long term basis?
✓ How to verify utilization of funds rasied for short term and long term basis.
Term Loans – normally have a fixed or predetermined maturity period or repayment schedule. In banking industry for ex loans with repayment period beyond 36 months are considered as terms loans.

Auditors should examine the terms & conditions subject to which the company has obtained the loan by verifying the relevant agreements and sanction letters. Auditor should then compare the purpose for which the loans were granted with the actual utilization of the loans.

Short term sources of funds include credit facilities like cash credit, overdraft, reduction in current assets, increase in current liabilities etc.

Long term sources of funds include equity, long term loans etc.

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.

Auditor should determine the amount of long term funds and long term application of funds using the balance sheet data. If the quantum of long term funds is significantly less than long term application of funds, it is an indication that short term funds have been used for long term assets of the Company.
 Clause (xviii): Issues of shares to 301 parties
Whether the terms and conditions are prejudicial in case of guarantees given by the company on behalf of others borrowings from banks and financial institutions

Clause (xix): Creation of securities for debentures
Whether securities have been created in respect of debentures issued

Clause (xx): End use of funds
Whether the management has disclosed the end use of money raised by public issues and the same has been verified. Auditor needs to also consider the listing agreement disclosures for reporting this clause.
Query:

How should the auditor report under this clause in a case where the company has invested surplus funds, not immediately required, in short-term loans/investments?

Response

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.
Query:

Is reporting under the clause required where the initial public issue was made in earlier years? If yes, for how many years back, is the auditor required to verify?

Response

Yes, reporting is required till such time the money raised is invested as per the stated objectives. The clause applies to all monies raised through public issues that were unutilized at the beginning of the period covered by the audit report or were raised through an issue in the period covered by the report.
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Clause (xxi): Reporting of fraud
Whether any fraud has been noticed or reported during the year. If yes, the nature and amount to be indicated

Compliance with SA 240 to ensured
Materiality is not a factor for reporting

Issues:

✓ How to ensure completeness
✓ Does it entrust more responsibility on auditors
Clause (xxi): Reporting of fraud

Two critical items reported by the FRRB in the shortcomings noted in the Journal of March 2009 as below:

(a) Fraud reporting on CARO should **not be limited to those instances which are material and which affects financial statements.** The FRRB has held that all instances of reported fraud irrespective of whether it is material or whether it affects financial statements, must be reported through CARO.

(a) All companies require to annex statements of investments showing the names of body corporate in which investments have been made subsequent to the last Balance Sheet date (whether existing or not on the Balance Sheet date). Many corporates do not comply with these requirements thereby violating the Schedule-VI.
CARO 2003 – The ‘Basics’
Clause wise listing

Support & Reference resources:

1. Guidance Note issued on statement of CARO by ICAI
2. FAQs on CARO issued by the ICAI
QUESTIONS?
THANK YOU!