

Companies (Auditor's Report) Order 2003- A Critical Analysis

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< EXECUTIVE SUMMARY >

◆ The Department of Company Affairs has notified the Companies (Auditor's Report) Order, 2003 which supersedes the existing Manufacturing & Other Companies (Auditor's Report) Order, 1988. The Propriety concept has made greater inroads in the new reporting order.

CARO 2003 puts no activity limitations, the clauses being applicable to all companies, excepting those specifically exempted under the said Order. The following article aims at critically examining the changes brought in by CARO 2003 and the issues arising therefrom.

INTRODUCTION



The Department of Company Affairs (DCA) notified the Companies (Auditor's Report) Order, 2003 [CARO 2003] vide GSR 480 (E) dated 12.06.2003 CARO 2003 supersedes the existing Manufacturing and Other companies (Auditors Report) Order, 1988 [Old Order].

The 20 clauses of the old Order will be replaced by 33 clauses of CARO 2003. The propriety concept has made greater inroads in the new reporting order. For example CARO 2003 requires reporting even about the end-uses raised in a public issue. CARO 2003 is applicable for every financial year ending on or after 1.7.2003.

The clauses of the Old Order were classified on the basis of the activity of the Company. Nevertheless, CARO 2003 puts no activity limitations, the clauses being applicable to all companies, excepting those specifically exempted under the said Order. This article aims at critically the changes brought in by CARO 2003 and the issues arising therefrom.

MAJOR CHANGES BROUGHT IN BY CARO 2003

The major changes envisaged by CARO 2003, when compared with the Old Order may be summarised as follows:-

- a) Changes towards more corporate disclosures and investor protection
- b) New clauses, which increase the protection of interest of the depositors/lenders
- c) Enhancement of certain limits/ coverage of reporting
- d) Procedural/ consequential changes

(A) Changes towards more Corporate Disclosures and Investor Protection

The Indian Corporate Sector is marching towards a better corporate governance with the series of amendments and disclosure requirements under the Companies Act. Further, the new generation Accounting Standards like AS 17 "Segmental Reporting", AS 18 "Related Party Disclosures", issued by ICAI throw more light on the internal working of the Company with more transparent disclosures.

One may find that the major emphasis of CARO 2003 is also towards further improving the corporate governance and creating the financial discipline to protect the interest of the investors. The changes envisaged in this direction are listed below:

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Old Order	CARO 2003	Remarks
<p>(a) Applicability</p> <p>Applicable to all Companies, except Banking, Insurance and Section 25 Companies (Preface)</p>	<p>In addition to companies listed in the Old Order, CARO 2003 exempts most of the Private Limited Companies. Only the following Private Companies are subject to reporting under CARO 2003:</p> <p>a) Companies having a Net Worth of more than Rs.50 Lakh paid up capital reserves)</p> <p>b) Which have accepted public deposit</p> <p>c) Which have outstanding borrowings of Rs.10 Lakhs or more, from any Bank or Financial Institution</p> <p>d) Whose turnover is in excess of Rs.5 Crores.</p>	<ul style="list-style-type: none"> * Most of the closely held Private Limited Companies and Companies operating in a small scale will be exempted from the application of the Order * Only Companies dealing with public money (deposits/ bank borrowings) are brought under lens. * Focus is also towards big Private Companies who may tap the capital market in the near future (Rs.5 Cr. turnover limit) * However, the general apprehension is that the exemption proposed for private companies will remain only in paper, as the limit fixed on the borrowing for exemption (i.e.) Rs.10 Lakhs is too low under the present economic conditions.
<p>(b) Fixed Assets</p> <p>No requirement to report about disposal of substantial portion of the fixed assets of the undertaking.</p>	<p>If the Company disposed off a substantial portion of its fixed assets, the auditor has to comment on the effect of the disposal on the enterprise, on the going concern concept (Clause 1(c))</p>	<ul style="list-style-type: none"> * While reporting under this clause, the auditor has to first check whether there is a substantial disposal of fixed assets. * Then he has to exercise his judgement to ascertain whether such disposal will affect the enterprise on the going concern concept, and to report thereof. * Disposal of a substantial portion of fixed assets is not defined in the Order. Under the Companies Act, the requirement of this Clause can be matched with the requirements of Sec 293 (1) (a) of the Act * Sec 293 (1) (a) of the Act requires prior permission of the shareholders to dispose of a substantial portion or portions of the undertaking. * This clause is intended to disclose the major decisions of the Board, which may affect the interest of the investors in the near future and to some extent is in line with AS 24 “Discontinuing Operations”
<p>(c) Transactions with related parties</p> <p>The responsibility imposed by the Old Order is only to examine and comment on the reasonableness of the pricing policy for transactions entered in the Register maintained u/s 301 (Clause xi)</p>	<p>* CARO 2003 changed the entire scope of the existing provision. The focus of the primary reporting under this clause is to report whether transactions that need to be entered into a Register in pursuance of Section 301 of the Act have been so entered [Clause v(a)]</p> <p>* Reporting on the reasonableness of the pricing is restricted to material transactions only</p>	<ul style="list-style-type: none"> * This Clause may be considered as a further step towards the investor’s protection. However the major issue here that the audit focus has to be shifted/ further intensified towards proprietary areas <ul style="list-style-type: none"> a) to find out the transactions that need to be entered (a thorough scrutiny of all entries in the books of accounts may be needed); and b) then to check the Register for actual recording of the same * Mere reliance on the 301 Register is not enough and the Auditor has to scrutinise Form No.24AA (Disclosure of interest by the Directors) to ascertain likely transactions that need to be entered in the 301 Register * It may result in changing to the role of an Investigator, searching for the traces of the entries with the related parties * It is interesting to note that while CARO 2003 requires reporting of all individual transactions, AS 18 “Related Party Disclosures” requires only disclosure of relationship, the indication of the volume of transactions and not to list all transactions.

<p>d) Pricing Policy</p> <p>To comment whether each of these transactions have been made at prices which are reasonable having regard to the prevailing market prices, if the aggregate amount of the transactions per party during the year is more than Rs.50,000/-</p>	<p>* The limit is increased to Rs.5 Lakhs</p> <p>* Market prices to be seen for transactions at the relevant time [Clause v (b)]</p>	<p>* CARO 2003 requires a comparison of the market prices for each transaction at the relevant time. If there are 100 transactions during the year, the arms' length price has to be tested for each such transaction during the time at which it had taken place and the reporting has to be done for each violation. This exercise may be cumbersome and time consuming.</p> <p>* Further, in respect of the continuous contracts for a specified period, determination of market prices at the relevant time of each transaction is a meaningless exercise.</p>
<p>(e) Internal Control System</p> <p>Under Clause (x), the Auditor is required to comment on</p> <p>a) Adequacy of internal control procedures for the purchase of inventory and fixed assets and for the sale of goods; and</p> <p>b) to report on the weaknesses observed</p>	<p>In addition, a continued failure to correct a major control weakness, which was observed and reported in the previous year(s), requires special mention in the audit report (clause iv)</p>	<p>* There may be situations where the Auditor or his predecessor had already qualified the Audit Report for inadequacy of internal controls in the previous year.</p> <p>* In framing the current year's Audit Report the Auditor has to</p> <p>a) Qualify the Audit Report with the nature of control weakness again; and</p> <p>b) Additionally, report the fact that there is a continued failure to correct the material control weakness</p>

(f) Other new clauses of CARO 2003 towards corporate disclosures

Clause under CARO 2003	Comments
<p>Default to Banks/ Financial Institutions</p> <p>The period and amount of default in repayment of dues to Financial Institutions or Banks or Debenture Holders has to be reported [Clause (xi)].</p>	<p>* The investor is now provided with an opportunity to understand the inherent financial problems of the enterprises, which are hitherto unavailable on the face of the financial statements.</p> <p>* It is to be noted that the Auditor will have to report under this clause, even if the default is made good substantially.</p>
<p>Guarantees given for others</p> <p>Details of the guarantee for loans taken by others from the Bank or Financial Institutions and to comment whether the terms and conditions whereof are prejudicial to the interest of the Company [Clause (xv)]</p>	<p>* There may be significant transactions with related parties during the year. But all of them may not come to the lime light by taking shield of the legal definition of related parties under the Act.</p> <p>* Financial Guarantees given for a loan taken by a third party may be a significant off-balance sheet transaction with related parties and any failure thereof may have a severe impact on the bottom lines of the Company</p> <p>* The Auditor is expected to report on these items and thereby related party transactions off the balance sheet is arrested.</p>
<p>End-use of term loans</p> <p>Clause (xvi) requires the Auditor to comment on whether term loans were applied for the purpose for which the loans were obtained; and Clause (xvii) requires</p>	<p>* This provision will really bring in hardship to the Auditor by extending the scope of audit beyond the books of accounts.</p> <p>* Cases of general borrowings will pose a practical problem, as it may not be possible to track the transaction till its end-use on one to one basis</p> <p>* Further since the meaning of the term "long-term investment" may</p>

reporting of whether the funds raised on a short-term basis have been used for long term investment and vice versa	vary on a case to case basis, reporting of whether the short-term funds are used for long-term investments and vice versa will require thorough application of mind.
Preferential allotment to related parties As per Clause (xviii) the Auditor has 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 an if so whether the price at which the shares, have been issued is prejudicial to the interest of the Company	<ul style="list-style-type: none"> * The parties listed in the 301 Register normally possess more knowledge about the internal working of the Company and are in a position to capitalise such information, before the same is made public * Any preferential allotment for a price less than the market price will warrant audit qualification * However, it may be remembered that the existing guidelines of SEBI in this direction is already more effective and it is expected that reporting under this Clause will not bring in any further protection to the investors.
End-use of public issue proceeds Clause (xx) requires to report whether the management has disclosed on the end use of money raised by public issues and the same has been verified	<ul style="list-style-type: none"> * Once again, Stock Exchanges already require the management to disclose the end-use of money raised by public issues and the Report requires certification by the Statutory Auditors * CARO 2003 also inserted a new clause to this effect. * The practical issue here is the plain reading of this clause requires a negative reporting even if the Company invested surplus funds not immediately required in short term loans/ investments, as the same may not be treated as the end-use of money raised
Reporting of frauds Reporting of any fraud on or by the Company noticed or reported during the year, including the nature and the amount involved [Clause (xxi)]	<ul style="list-style-type: none"> * AAS 4(Revised), “The Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements”, guides the Auditor to obtain a management representation letter as the frauds reported and detected during the year because of the nature of the fraud and the difficulties encountered by the Auditors in detecting material misstatements in the financial statements resulting from fraud. Accordingly, it may be concluded that it is enough if the Auditor expresses his opinion on the frauds noticed and reported by the management and not expected to be a detective to approach his work with suspicion * Another major issue under this clause is it also requires reporting of frauds committed by the Company. The Auditor is left with no clues and is expected to travel beyond the books to search for market information about frauds committed by the Company, which is highly illogical.

(B) Clauses increasing the protection of interest of Depositors/Lenders

A mere protection to the investors is not enough in shaping the economy to the desired levels. More focus is also required to protect the interests of the passive stakeholders (viz) the depositors and lenders. The following Clauses of CARO 2003 bring in more areas under the ambit of the Auditors’ review and reporting towards this direction:-

Old Order	CARO 2003	Remarks
(a) Acceptance of Public Deposits When the Company has accepted fixed deposits from the public, the auditor	<ul style="list-style-type: none"> * Not only section 58A but also the compliance of Sec 58AA has to be commented upon * In cases of default listed u/s 58AA and if the Company Law Board (CLB) had passed any order, the Auditor should also report whether the said order has been 	<ul style="list-style-type: none"> * The Companies (Amendment) Act, 2000 inserted a new Section 58AA which requires every Company to intimate to the CLB, on a monthly basis, any default made by it in repayment of full or part of small deposits (Rs.20000) or any interest thereupon. * If any default is reported, the CLB shall pass

has to comment upon whether the provisions of Sec 58A is complied with	complied with or not (Clause vi)	an order to prevent the Company from accepting further small deposits until it repays the existing dues. * CARO 2003 more effectively protects the interests of small depositors by casting a further responsibility on the Auditor to report on the compliance of Sec 58AA and the order issued by the CLB, if any.
(b) Debenture holders No reporting requirement under the Old Order	Clause (xix) of CARO 2003 requires the reporting of whether securities have been created in respect of debentures issued	* The legal protection is extended even to the Debenture Holders under CARO 2003
(c) Nidhi/ mutual benefit fund/ societies Only limited reporting was necessary under the old Order	Now the scope of reporting is extended as per Clause (xiii) to cover the following:- (a) whether the net-owned funds to deposit liability ratio is more than 1:20 as on the date of the 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	* The nidhi/ mutual benefit funds, being Non-Banking Finance Companies, are already covered by the RBI rules with regard to the maintenance of debt-equity ratio, compliance with the prudential norms etc., * However, the returns filed with the RBI narrating the defaults etc., hitherto go unnoticed, as Companies are not under any legal compulsion to disclose the same to the users of financial statements. * By bringing these items under review, it is expected that more information about the solvency of these Companies will be made available to the public, in the days to come.

(C) Enforcement of limits/ coverage of Reporting

On the one hand, CARO 2003 increased certain limits specified under the Old Order, but on the other it widened the reporting requirements and made the Auditor more accountable. These areas are listed below:-

Old Order	CARO 2003	Remarks
(a) Internal Audit The Auditor has to comment on Internal Audit System that the Paid-up Capital is more than Rs.25 Lakhs; or Average annual turnover is more than Rs.2 Cr. for three consecutive financial years	* CARO 2003 revised the limits to Rs.50 Lakhs and Rs.5 Crores respectively. * All listed Companies are now covered under this clause	* CARO 2003 requires the Auditor to comment upon the Internal Audit System in the case of all Listed Companies, even if they do not meet the threshold limits. It is a welcome change from the investors' point of view * However, it may be noted that the Companies Act does not contain a provision making the internal audit compulsory for any Company

<p>(b) Payment of Statutory Dues Clause (xvii) requires reporting as to whether the Company is regular in depositing the PF and ESI dues with the appropriate authorities. If not, the extent of arrears to be stated.</p>	<p>CARO 2003 extends the scope to cover, additionally, the following contributions as per Clause ix (a)</p> <ol style="list-style-type: none"> Investor Education & Protection Fund Income Tax Sales Tax Wealth Tax Customs Duty Excise Duty Cess Any other Statutory dues 	<ul style="list-style-type: none"> * It is not clarified whether a regular deposit of Income Tax means only taxes on income alone or includes TDS also * By covering the Sales Tax, Customs, Excise, Cess and all other statutory dues, the Auditor is required to step into the shoes of a Tax Auditor also. * As CARO 2003 requires reporting of the extent of arrears, the Auditor has to examine the arrears on a month to month basis while framing his report under the new Order
<p>(c) Undisputed statutory liabilities The undisputed amounts payable in respect of Income Tax, Wealth Tax, Sales Tax, Customs Duty and Excise Duty which are outstanding as on the Balance Sheet date for a period of more than six months required to be reported by the auditor (Clause xviii)</p>	<p>Now all Statutory dues outstanding for more than 6 months are covered and the reporting requirement is merged with Clause ix (a) of the Order</p>	<ul style="list-style-type: none"> * Extended coverage will bring in more information about the existence of statutory liabilities and the impact thereof
<p>(d) Disputed Statutory Liabilities Under the Old Order, only undisputed liability towards taxes warrants the reporting by the Auditors</p>	<p>Now even the disputed has to be reported on the following lines as per Clause ix(b)</p> <ol style="list-style-type: none"> the amounts involved and The forum where the dispute is pending may be mentioned. 	<ul style="list-style-type: none"> * The Companies are usually reporting these items in the note to the accounts, as contingent liability not provided for. * However, often these disclosures will not provide much information about the liability to the users of the financial statements, in the absence of information as to the status of the dispute * An opportunity is now provided to the users to exercise their judgement to ascertain whether there is any possibility of the disputed liability becoming actual liability and its likely impact on the financial statements.

(D) Procedural/ Consequential Changes

CARO 2003 also revamps certain inconsistencies in the Old Order by amending and/or deleting certain clauses. These procedural and/ or consequential changes are listed below:-

Old Order	CARO 2003	Remarks
<p>(a) Revaluation of Fixed Assets The Auditor has to report on the revaluation of fixed assets</p>	<p>Clause removed</p>	<ul style="list-style-type: none"> * Understanding the basis of the revaluation of the fixed assets and reporting thereof requires a lot of technical expertise * In most of the cases, no real value addition will be done by the Auditors, as they have to merely rely upon the technical reports by the third parties

during the year and the basis thereof (Clause ii)		<ul style="list-style-type: none"> * It may be noted that Schedule VI requires the details of revalued assets to be disclosed in the fixed assets schedule for 5 years from the year of revaluation. * In other words, the Auditor is required to continue certifying information on revaluation of fixed assets even after the application of CARO 2003
<p>(b) Stock valuation</p> <p>Clause (vi) of the Order requires the Auditors to comment on whether the valuation of the stock is fair and proper in accordance with the normally accepted accounting principles and is on the same basis as in the preceding year.</p>	Provision deleted	<ul style="list-style-type: none"> * AS 2 “Valuation of Inventories” and AS 5 “Net Profit or Loss for the Period, Prior Period Items and Changes in Accounting Policies” are mandatory standards referred to in Sec 211 (3C) of the Act * Accordingly, every deviation from the generally accepted accounting principles as well as the change in the accounting policy still warrant auditors’ qualification * In other words, the deletion will not really relieve the Auditor from his responsibility to report on the inconsistencies in the accounting policy as regard the stock valuation
<p>(c) Loans taken/ given by the Company</p> <p>The Auditor has to comment whether reasonable steps are taken for the recovery of the overdue principal in respect of all loans [Clause (ix)]</p>	Only if the overdue loan is more than Rs.1 Lakh, then this requirement arises [Clause iii (d)]	<ul style="list-style-type: none"> * Despite the concept of materiality, the earlier Order necessitated the coverage of even small loans pending the recovery * The present Order will enable the Auditor to focus on the material cases only, thereby further increasing the quality of the report. * However, it may be noted that this Clause covers not only loans given, but also loans taken. Accordingly the Auditor has to comment on the steps taken to repay the overdue loans of Rs.1 Lakh or more owed by the Company.
<p>(d) Unserviceable/ damage goods/ scrap and by products</p> <p>* Clause (xii) requires the Auditor to report whether the Company has a regular procedure for determination of unserviceable or damaged stores, raw materials and finished goods in their accounting treatment</p> <p>* Clause (xiv) requires the Auditor to report whether the Company is maintaining reasonable records for the sale and disposal of realisable scrap and by-products.</p>	Both the Clauses were removed in CARO 2003	<ul style="list-style-type: none"> * In preparation of the general purpose financial statements the concept of materiality normally plays a vital role * There were innumerable instances of dispute between the Auditors and the technical people as to the determination and valuation of damaged, unserviceable goods, scrap and by products. * It can not be denied that to some extent an expert technical knowledge is required to decide on the realisable value and accounting for the differences * In practical sense, in most of the cases, the value involved may not be material with regard to the size of the business. * Unnecessary disputes/ qualifications in the Audit Report are now avoided with the removal of these clauses
<p>(e) Personal Expenses</p> <p>Clause (xix) requires to report whether during the course of audit the Auditors have come across any personal expenses of the employees or the Directors which have been charged to revenue</p>	Clause omitted under CARO 2003	<ul style="list-style-type: none"> * With the increased Stress on Corporate Governance, Companies are forced to offer an attractive pay structure to retain/ recruit good talents * In the move, the Companies are to extend even reimbursement of personal expenses based on contractual obligations. * The DCA might have thought that this Clause is no more relevant in the present scenario and accordingly deleted the same. * However, even in the absence of this Clause, the Auditor will have to check whether personal expenses are charged to revenue u/s 227 (1A)

<p>(f) Loans to companies under the same management Loans to and from the Companies under the same management as defined u/s 370 (1B) need the Auditors' comments</p>	Provisions deleted	* The erstwhile Section 370 (1B) was already deleted by the Companies (Amendments) Act 2000 but the corresponding changes were not made in MAOCARO, 1988. It forced the Auditors to continue reporting under Sec. 370 (1B) despite the fact that there is no legal requirement under the parent Act.
<p>(g) Sick Industrial Companies Clause (xx) requires reporting whether the Company is not a sick industrial company within the meaning of Clause 'O' of sub-section (i) of section 3 of the Sick Industrial Companies (Special provisions) Act, 1985. (SICA)</p>	<p>The clause was re-drafted and the Auditor has to report whether in case of a Company which has been registered for a period not less than five years</p> <p>a) its accumulated losses at the end of the financial year are not less than fifty per cent of its net worth; and</p> <p>b) whether it has incurred cash losses in such financial year and in the financial year immediately preceding such financial year also</p>	* Since SICA was abolished at least on paper, the reporting requirements are redefined under CARO 2003.
<p>(h) Reference to BIFR In case a reference is made to BIFR, the details thereof need be reported</p>	Clause deleted in CARO 2003	* With the formation of the National Company Law Tribunal, the powers vested with the BIFR is now shifted to the Tribunal
<p>(i) Activity based clauses Special Clauses as to Service companies and Trading Companies</p>	Totally deleted in CARO 2003	As CARO 2003 is made applicable to all Companies without any activity limitation, the deletions are only consequential in nature

CONCLUSION

A close watch of the provisions of CARO 2003 will reveal that there is a paradigm shift in the reporting requirements. The Auditor reports in his main report that audit includes examining of evidence supporting the amounts and disclosures in the financial statements, on a test basis. But he may contradict his own statement when reporting under CARO 2003, as a 100% audit is required for reporting under most of the clauses. The traditional concept of "statutory auditors are watch dogs" will no longer valid, as CARO 2003 makes auditors more accountable. The accounting professionals may contend themselves with observing that with the increased emphasis on greater corporate disclosures, investor and creditors' protection, the Companies (Auditor Report) Order, 2003 would improve financial discipline and quality of the corporate governance in the Indian Corporate Sector. ■