AAS 1 – Basic principles governing an Audit :

Basis	Accounting
1. Integrity, objectivity and independence	(a) Auditor should be straightforward, honest and sincere in his profession work. (b) He should be fair and must not be biased. (c) He should maintain impartiality. He should be free of any interest.
2. Confidentiality	(a) He should maintain confidentiality of information acquired during his work. (b) He should not disclose any such information to a third party without specific permission of client or legal or professional duty to disclose.
3. Skill and competence	(a) He should perform work due professional care. (b) Audit should be performed by persons having adequate training, experience and competence.
4. Work performed by others	(a) The auditor can delegate work so assistants or use work performed by other auditors and experts. (b) But he will continue to be responsible for his opinion on financial information. (c) The Auditor is entitled to rely on work performed by others, provided • He exercise adequate skills and care and • There is nothing to doubt.
5. Documentation	(a) He should document matters relating to the audit (maintain working papers). (b) Working papers are maintained to demonstrate that the audit was carried out in accordance with the basis principles.
6. Planning	(a) He should plan his work to conduct audit in effective by performing compliance and substantive procedures. (b) Plans should be based on knowledge of the clients business. (c) Plans should be further developed and revised during audit if circumstances require so.

7. Audit Evidence	(a) Auditor should obtain sufficient and appropriate audit evidence by performing compliance and substantive procedures. (b) Evidences enable the auditor to draw reasonable conclusion. (c) Compliance procedures mean the test designed to obtain reasonable assurance that internal controls have been properly designed & operating effectively throughout the year. (d) Substantive Procedures are performed to obtain evidence as to the completeness, accuracy and validity of data produced by the accounting system.
8. Accounting system and internal control	(a) Internal control system ensures that the accounting system is adequate and that all the accounting information has been duly recorded. (b) The auditor should understand the accounting system and related internal controls adopted by the management. (c) He should study and evaluate internal controls system to determine the nature, timing and extent of other audit procedures.
9. Audit conclusions and reporting	(a) The auditor should review and assess the conclusions drawn from the audit evidences obtained through performance of procedure. (b) The audit report should contain clear written expression of opinion on the financial statements. (c) His report is on whether : • The financial information has been prepared using acceptable accounting policies which have been consistency applied; • The financial information complies with relevant regulation and statutory requirements; and • There is adequate disclosure of all material matters. (d) The report should be as per legal requirement. When other than clean opinion is given, the audit report should state the reasons thereof.

Objectives of Audit :

Primary	**As per AAS-1**	Audit is conducted to express an opinion on financial statements. Thus, primary objectives is Reporting.
Objective	**As per AAS -2**	The objective of audit of financial statement is to enable the auditor to express an opinion on such financial statements.
	Reporting on What?	The auditor reports whether financial statements represent true & fair views.
	True & fair Meaning	It can be examined by considering whether :
		(a) Financial statement have been prepared using consistent & acceptable accounting policies & (b) Financial statements comply with relevant rules & regulations & (c) Financial statements contain disclosure of all material matters.
Secondary Objective	**Detection of Misstatement**	(a) Auditor is expected to provide opinion on true & fair view of financial statement as above. (b) He cannot frame such opinion if he is not able to confirm / dispel the possibility of existence of fraud & error in financial statement. (c) Thus incidental / secondary objective is detection of misstatement in financial statements.

	As per AAS - 4	(a) Primary responsibility of prevention, detection & correction of fraud and error is that of management. (b) However, if there are doubtful situation that some material misstatement may exist, auditor should extent his procedure to confirm / dispel the doubt. (c) Audit may not reveal all the misstatement (due to inherent limitations of audit). (d) If auditor performs his work in accordance with basic principles governing an audit, he cannot be held liable for non-detection of misstatement in financial statement of client. (e) However, if he notices material misstatement resulting from fraud, he should communicate the same at appropriate level of management. (f) If misstatements are found, he should ensure their appropriate disclosure either in financial statements by the management or in his audit report.
	As per case of "Kingston cotton mills company"	(a) Unless doubtful situations are there, auditor is totally justified in relying upon the management / employees of the client. (b) He is a watchdog not a blood hound.

AAS 2 – Objectives And Scope of the Audit of financial Statements :

Basis	**Accounting**
Objectives of an Audit	(a) The objective is to be enable the auditor to express an opinion on financial statements prepared by management of entity. (b) For this, it is essential that financial statements are prepared as per the recognized disclose all material matters. (c) However, his opinion does not constitute an assurance as to future viability of the enterprise or the efficiency or effectiveness with which its management ha conducted the affairs of the enterprise.

Responsibility for the financial statements	(a) The management is responsible for maintaining an upto date and proper accounting system and finally to prepare financial statements. (b) The auditor is responsible for forming and expressing an opinion on the financial statements. (c) The audit of the financial statement does not relieve the management of its responsibility.	
Scope of an audit	The auditor decides the scope of his audit having regard to : ⇒ The requirement of the relevant legistation. ⇒ The pronouncements of the institute (ICAI) ⇒ Terms of engagement However, the terms of engagement can not supersede the pronouncement of the institute or the provisions of relevant legislation.	
Inherent limitations of audit – What are these?	1. Test checking	(a) Auditor uses sampling during performance of audit. (b) Its not possible for him to conduct detailed checking due to time constraints and other practical problems. (c) As he does not check each & every item, it's impossible for him to detect all fraud & errors.
	2. Nature of evidence	(a) The evidences obtained by the auditor are persuasive rather than conclusive. (b) They can't ensure the auditor in a certain way. (c) They can enable auditor to draw only reasonable conclusions there from (not absolute conclusions).
	3. Involvement of Judgement	(a) Auditor exercise judgement in evaluation the reasonableness of judgement & estimates made by the management in preparing the financial statements. (b) The judgement by auditor may not always be correct.

	4. Inherent limitations of internal controls	(a) Internal controls suffer from limitation such as collusion among employees or wrong use of authority by management etc. (b) If internal controls are weak, auditor may not be in a position to obtain assurance.
Limitations on scope – effect on audit report	If there are any constraints as regards the scope of audit, he should mention them in his audit report.	
Organising an audit	1. Auditor should conduct audit in such a way that he would be able to obtain sufficient and appropriate audit evidence. 2. He should cover all – important aspects affecting financial statement of the client. 3. If there is indication of misstatement, he should extent his audit procedures.	

AAS – 3 Documentation (Revised)

Basis	Accounting
1. Documentation	1. Auditor should keep sufficient and appropriate documentation to provide a record of basis for auditors report & to demonstrate that audit was performed in accordance with AAS & applicable legal and regulatory requirements.
	2. Documentation (working papers) is the record of audit procedures performed, relevant audit evidence obtained and conclusions the auditor reached.
2. Other Requirement	1. It may be recorded on paper or electronic or other media. 2. Audit documentation for a specific audit engagement is assembled in an audit file.

3. Purpose of audit documentation	1. Assisting Audit team to plan and perform the audit. 2. Assisting members of audit team to direct / supervise the work etc. as per AAS -17. 3. Demonstrating the accountability of Audit team for its work. 4. Retaining a record of matters of continuing significance to future audits of the entity. 5. Enabling an experienced auditor to conduct reviews as per statement on Peer Review. 6. Enabling an experienced auditor to conduct external reviews as per applicable legal or other requirement.
4. Form, Content and Extent of Audit Documentation	Auditor should prepare documentation that enables an experienced auditor, having no previous connection with the audit, to understand 1. Nature, timing, extent (NTE) and results of Audit procedures. 2. Audit Evidence obtained. 3. The conclusions reached on significant matters. 4. In relation to audit procedures designed to address identified risk of material misstatements, conclusions that are not otherwise readily determinable from the documentation of procedures or evidence.
5. Inconsistency in audit evidence	If auditor has identified audit evidence that contradicts / is inconsistent with auditor's final conclusion regarding a significant matter, he (auditor) should document how he addressed the contradiction.
6. Auditor should record these also	1. Auditor should document (a) Oral discussion; and (b) Management response. 2. He should also document : (a) Who performed the audit work and date of such work. (b) Who received specific audit documentation and date of such review. (c) Identifying characteristics of the specific item tested. (d) If an exceptional circumstances, auditor departs from basic principle or procedure in an AAS, he should document the reasons for the same.

7. Change in documentation	(a) After date of audit report, if (in exceptional situations) auditor performs new procedures etc. he should document the changes necessary including : (i) When and by whom such changes were made and reviewed (if applicable); (ii) Specific reasons for the changes; and (iii) The effect (in any) of changes (b) After completing Audit file, auditor shouldn't delete any documentation of new information received after date of audit report.
8. Auditor's Duties	(a) Auditor, should (regarding documentation) (i) Maintain its confidentiality and safe custody; (ii) Protect its integrity (iii) Enable its accessibility and irretrievability; and (iv) Enable its retention for a period sufficient to meet the needs of the firm and legal and professional requirements (subject to legal requirements but not shorter than 10 year from the date of audit report). (b) He should adopt proper control procedure to maintain integrity, accessibility and irretrievability of data whether documentation is in paper, electronic or other media. (Note ; This AAS is applicable with effect from 1st April, 2005)

AAS-4 The Auditor's Responsibility to consider fraud and error in an audit of finance statements

Fraud	**Nature**	**International**
	By whom*	• Employees, or • Management, or • Those charged with governance, or • Third parties
	Example -	• Falsification of accounts • Misappropriation of assets • Suppression of transactions • Omission of effects of transactions • Wrong accounting procedures • Misapplication of accounting Policies
Error	**Nature**	Unintentional

<table>
<tr><td rowspan="2"></td><td>By whom</td><td>Unintentional</td></tr>
<tr><td>Example</td><td>• Mathematical mistakes
• Oversight of facts
• Misapplication of Accounting Policies</td></tr>
<tr><td rowspan="2">Responsibility</td><td>On part of those charged with Governance & Management</td><td>• Prevention & detection of fraud & error is their responsibility.
• For this, management establishes suitable internal control system.</td></tr>
<tr><td>On part of Auditors</td><td>• He must work in accordance with AAS.
• If there is indication on misstatement, he should extend his procedures to confirm / dispel the doubt.
• He should maintain documentation.
• But he can't be held responsible for prevention of fraud & error.
• If auditor works in accordance with AAS, he can not be held responsible for non-detection of fraud or error.</td></tr>
<tr><td>Inherent limitations of audit due to which detection of all misstatements is not possible</td><td colspan="2">• Test nature of Audit (Sampling).
• Professional judgment of Auditor.
• Persuasive nature of Audit evidence rather than conclusive.
• Limitations of internal control system.</td></tr>
<tr><td rowspan="2">Discussion and inquiries</td><td>With members of audit team</td><td>Probability of Fraud and Error in financial statements.</td></tr>
<tr><td>With management</td><td>Regarding fraud by management.</td></tr>
<tr><td rowspan="3">Management representation letters that auditor should obtain regarding</td><td colspan="2">(a) Management responsibility for accounting and I.C. system to prevent and detect & correct Fraud and Error.</td></tr>
<tr><td colspan="2">(b) Aggregate uncorrected misstatements are immaterial for financial information in opinion of management.</td></tr>
<tr><td colspan="2">(c) It has disclosed the auditor all facts regarding –
• Known frauds &
• Suspected frauds.</td></tr>
</table>

If auditor has indication of misstatement (i.e. doubtful situation)
↓
He should carry out extended procedures in respect of same

Doubt is dispelled | Doubt is confirmed | Unable to conclude
↓ | ↓ | ↓
O.K. | He should consider whether it is indicative of error or fraud | He should consider disclosure in financial statement

Error | Fraud | If mgt. does it | Else
 | ↓ | ↓ | ↓
 | He should Consider its Effects | O.K. | Effect on A.R.

He should ask mgt. for suitable disclosure In Financial Statements

- If mgt. does it – O.K.
- Else – effect on A.R.

COMPANY AUDITOR : APPOINTMENT AND REMOVAL

ELIGIBILITY FOR APPOINTMENT OF AN AUDITOR

Sec. 226 of the Companies Act, 1956 lays down provisions regarding the eligibility of appointment of an auditor. These provisions are applicable to all types of companies, be it a private company, a public limited company, a government company or a licensed company.

Auditor's qualifications

The main purpose of section 226(1) and (2) of the Act is to ensure that only a qualified person possessing the requisite professional knowledge and technical skills is appointed as an auditor. The prescribed qualifications under Sec. 226 are:

Chartered accountant in practice : A person who is a chartered accountant within the meaning of Chartered Accountants Act, 1949 and holds a certificate of practice.

Partnership firm of chartered accountants in practice : A partnership firm where all the partners practicing in India are chartered accountants holding certificate practice, may also be appointed as an auditor of a company. In such a case, the appointment of an auditor may be made in the name of the firm and any partner may act in its name.

Holder of a certificate in erstwhile Part 'B' States : Sec. 226(2) provides that a holder of a certificate in erstwhile Part 'B' states is also eligible for appointment as an auditor, subject to rules framed by the Central Government relating to the grant, renewal, suspension or cancellation of auditor's certificate. This provision has now become redundant.

Disqualifications of an auditor

The object of Sec 226(3) and (4) is to ensure independence of the auditor. Accordingly, none of the following persons shall be qualified for appointment as an auditor of a company:

(i) A body corporate (because of its characteristic feature of limited liability); or

(ii) An officer or employee of the company under audit; or

(iii) A person who is a partner or who is in the employment of an officer or employee of the company

(iv) A person who is indebted to the company for an amount exceeding one thousand rupees, or who has given any guarantee or provided any security in connection with the indebtedness of any third person to the company for an amount exceeding one thousand rupees; or

(v) A person holding security, i.e. an instrument which carries voting rights of that company after a period of one year from the date of commencement of the Companies (Amendment) Act, 2000. If he is a security holder, then he should sell or transfer the security held by him in the company within one year from the date of commencement of the Amendment Act and

(vi) Under section 226(4), a person who has been disqualified for appointment as an auditor of a company on above-mentioned grounds, shall also not be eligible for appointment with any other body corporate which may be that company’s subsidiary or that company' s holding company or that company's fellow subsidiary.

Sec. 8 of the Chartered Accountants Act, 1949 has also mentioned additional grounds for disqualification to which an auditor is subjected to.

Automatic vacation on becoming disqualified

According to Sec. 226(5), if an auditor after his appointment becomes disqualified on account of provisions of Sec. 226(3) and (4), he shall he deemed to have vacated his office automatically.

APPOINTMENT OF AUDITORS

Under section 224 of the Act detailed provisions regarding appointment of statutory auditors have been laid down. This section (except section 224A and 224(1B)] is applicable to all kinds of companies. The Act has vested the power to appoint auditors with directors, shareholders, the Central Government and the Comptroller and Auditor General of India.

Appointment by directors:

First Auditors - The board of directors shall appoint the first auditor(s) of a company within one month of the date of registration of the company by a valid resolution. Mere inclusion of the name of the auditor in the articles of association is not sufficient for being appointed as first auditor. The auditor so appointed shall hold office till the conclusion of first annual general meeting.

Casual Vacancy - The directors have been empowered to fill any casual vacancy in the office of the auditor, except one, which is caused by prior resignation of an auditor. Any auditor appointed in a casual vacancy shall hold office until the conclusion of next annual general meeting.

Appointment by shareholders :

FIRST AUDITORS - In case the directors fail to appoint first auditor(s), the shareholders shall appoint the auditor at a general meeting by passing a resolution.

SUBSEQUENT AUDITORS

(i) By ordinary resolution:

As per provisions of section 224(1), subsequent auditors are to be appointed at each annual general meeting by the shareholders by passing a resolution. The tenure of the auditor so appointed would be from the conclusion of that meeting until the conclusion of the next annual general meeting.

In case the next annual general meeting is not held when it was ought to be held, the auditor will continue in office until the next annual general meeting is actually held and concluded. In the event of adjournment of the annual general meeting, the auditor will continue in office till the conclusion of adjourned meeting.

The company shall, within seven days of the appointment give intimation thereof, to the auditor so appointed. The auditor shall inform, in writing, to the Registrar of Companies within thirty days of the receipt of the intimation of his appointment, as to whether he is accepting or refusing the appointment.

(ii) By special resolution:

In case of certain companies, the auditor is to be appointed only with the approval of the company by a special resolution. Section 224A lays down that in case of a company, in which not less than twenty-five per cent of the subscribed share capital is held, whether singly or in any combination, by :

(a) A public financial institution or a Government company or Central Government or any State Government; or

(b) Any financial or other institution established by any provincial or State Act in which a State Government holds not less than 51% of the subscribed share capital; or

(c) A nationalised bank or an insurance company carrying on general insurance business, the auditor is to be appointed or re-appointed by a special resolution only.

The auditor so appointed should also be informed and he should also communicate his acceptance / non-acceptance to the Registrar. The Government has clarified that for the purposes of section 224A, the composition of shareholding shall be the day of the closure of membership register before the scheduled date for holding the annual general meeting.

Further the above three categories are not mutually exclusive i.e. to determine the applicability of section 224A(a), (b) and (c) would be aggregated.

- **CASUAL VACANCY**

  If a casual vacancy in the office of auditor arises by his resignation, such vacancy should only be filled by the company in a general meeting (not necessarily the annual general meeting). In case a casual vacancy arises because of any other reason except resignation, the shareholders can appoint the auditor only if directors fail to fill the vacancy.

Appointment by the Central Government :

(i) If a company, at an annual general meeting, fails to appoint or re-appoint an auditor(s), the Central Government may appoint a person to fill the vacancy under powers conferred upon it by section 224(3). The expression 'fails to -- or re-appoint' also includes refusal to accept the appointment by the auditor.

(ii) The said company has to give notice of the above fact to the Government and, if a company fails to give such notice within seven days of the annual general meeting, the company and every officer of the company who is in default shall be punishable with fine, which may extend up to five thousand rupees.

(iii) The appointment by the Central Government is made from the panel of names suggested by the applicant company.

(iv) It may be noted that if appointment of a person as an auditor is void ab initio*,* it should not be treated as a casual vacancy, rather this would give rise to powers of the Central Government under section 224(3).

Appointment by the Comptroller and Auditor General :

In case of government companies (as defined under section 619) and in case of companies having considerable public interest (section 619B), the Comptroller and Auditor General appoints or re-appoints the auditor(s).

Compulsory re-appointment :

Ordinarily, an auditor appointed by whatsoever authority, is to be compulsorily re-appointed by passing a resolution at the annual general meeting. However, the retiring auditor shall not be re-appointed in the following cases :

(i) If he is not qualified for re-appointment; or

(ii) If he has given the company notice in writing about his unwillingness to be re-appointed

(iii) If a resolution has been passed at the meeting-

  (a) Appointing somebody other than him; or

  (b) Providing expressly that he shall not be re-appointed or

(iv) if a notice has been given of any resolution proposing the appointment of some other person in place of the retiring auditor (even if such a resolution could not be proceeded with due to death, incapacity or disqualification of that person proposed as auditor); or

(v) If auditor is unable to comply with the ceiling on number of audits under sec 224(1B).

Even for re-appointment of a retiring auditor, passing of a resolution is essential. There cannot be any automatic re-appointment.

Summary of appointment, removal, resolution

Sr. No.	Which	By Whom	Appointment of Auditor When	How
1)	First Auditor	BOD	< 30 Days of incorporation	BOD meeting
		If BOD Fails Than by S.H.	In 1st AGM	Ordinary resolution
			If > 25% shares held by specified entities*	By Special Resolution
		If S.H. fails Then by C.Govt.	Within 7 days of AGM intimate to C.Govt.	
2)	Re-appointment	By S.H.	1) in GM	Ordinary Resolution
			2) If > 25% shares held by specified entities*	Special Resolution
		If S.H. fails	Within 7 days of AGM	

		Then by C.Govt.	intimate to C.Govt.	
3)	Casual Vacancy			
a)	If Vacancy due to Resignation, removals	By S.H. at AGM	1) Normally by Ordinary Resolution	
			2) If > 25% shares held by specified entities*	By Special Resolution
		If S.H. fails Then by C.Govt.	Within 7 days of AGM intimate to C.Govt.	
b)	If Vacancy due to Other reasons like insolvency, death lunacy	BOD	In BOD Meetings	Ordinary resolutions
		If BOD Fails Than by S.H.	In next GM	Ordinary resolution
		If S.H. fails Then by C.Govt.	Within 7 days of AGM intimate to C.Govt.	
4)	Government companies	By C.Govt. on advice from C&AG	In GM	Ordinary resolution

* **Specified entities:** if more than 25% shares held by public FI like IDBI, ICICI. IFCI, or State Government or central Government or Government companies or two or more Government, or more than 25% shares held by state financial institutions (where more than 51% shares are held by either State government or Centrsl government)

CEILING ON NUMBER OF AUDITS

The auditor, who has been appointed or re-appointed under section 224, has to comply with the ceiling on number of audits prescribed under section 224(1B). Before such appointment or re-appointment, a certificate in writing is required to be obtained by the company from the auditor regarding compliance of such ceiling. The objective of such a ceiling is to prevent concentration of audits in few hands.

- In case of individuals, the specified number of audit stands at twenty. Moreover, out of these twenty companies not more than ten should be companies having a paid-up share capital of Rs.25 lakhs or more.
- In case of partnership firm of auditors, the ceiling is twenty companies per partner of the firm. If a partner is also a partner in any other firm or firms of auditors, the number of audits held by him individually and/or by different firms on his account should be taken note of for the purpose of computation

of ceilings under section 224(1B). Moreover, any partner who is in full-time employment elsewhere, is not to be taken into account while computing the ceiling of number of companies that the firm can audit. The number of partners of a firm on the date of acceptance of audit assignment shall be taken into account.

For example, A and B are partners in the firm AB & Co. A is also a partner in AC & Co., which holds, audit of seven companies on his account, three of which have a paid-up capital of Rs. 25 lakhs or more. In this case, AB & Co. can hold audit of not more than thirty-three (33) [10+10+(10-4)+(10-3)] companies out of which not more than seventeen companies should have a paid-up capital of Rs. 25 lakhs or more.

- Each of the joint auditors or the firms who are appointed as joint auditors shall count the joint audit assignment as one company audit separately. Part audit and Audit of non-profit companies are counted for determining ceiling.
- The following audits are not considered for purpose of calculating the specified number of audits :
  - (i) Audit of private companies.
  - (ii) Audit of branches of Indian and foreign companies
  - (iii) Audit of guarantee companies not having share capital.
  - (iv) Audit of statutory corporations.
  - (v) Investigations.
  - (vi) Audit of foreign companies.
  - (vii) Special audit.

REMUNERATION OF AUDITOR

Section 224(8) of the Act has laid down provisions for remuneration of auditors of a company.

Who would fix remuneration

In case of auditors appointed by the board of directors, the board is authorised to fix the remuneration of the auditors.

In case of auditors appointed by the shareholders in general meeting, whether by ordinary or special resolution, the remuneration shall be fixed in the general meeting or in such manner as it may determine. It may even delegate powers to fix the remuneration to the board of directors.

In case of auditors appointed by the Central Government, remuneration may be fixed by the Central Government.

In case of an auditor appointed under section 619 for Government companies by the

Comptroller and Auditor General of India, remuneration shall be fixed by the c-ompany in general meeting or in such manner as the general meeting may determine.

<u>Remuneration includes what</u>

The remuneration fixed for an auditor is inclusive of all expenses. However, for legal or technical advice sought by him in connection with his duties as an auditor, he can claim the expenditure from the company.

The auditor, besides remuneration for audit work, may also be paid extra remuneration for services rendered in any other capacity and such payment shall be disclosed in the Profit and Loss Account in the manner provided in Part II of Schedule VI to the Act and would, thus, be classified as –

1. As auditor
2. As adviser, or in any other capacity, in respect of
   - (a) Taxation matters:
   - (b) Company law matters; and
   - (c) Management services.
3. Other amounts paid in any other manner.

REMOVAL OF AUDITOR

<u>Removal of auditor before the expiry of the term</u>

Section 224(7) of the Act contains provisions relating to removal of an auditor of a company before the expiry of term. The purpose of this section is to make the removal of an independent and conscientious auditor difficult.

- **<u>REMOVAL OF FIRST AUDITOR</u> -** The company (and not the board of directors) in a general meeting (not necessarily annual general meeting) can remove the first auditor appointed by the directors before the expiry of his term. The procedure to be followed is similar to the appointment of a new auditor in place of a retiring auditor. It may be noted that the Central Government's approval is not for removal of first auditor.
- **<u>REMOVAL OF SUBSEQUENT AUDITOR</u> -** Any subsequent auditor can be removed from office before the expiry of his term, only by the company in its general meeting, after obtaining the prior approval of the Central Government and following the same procedure as laid down for appointment of an auditor in place of a retiring auditor.

<u>Appointment of an auditor in place of a retiring auditor</u> :

Section 225 has laid down procedure for appointment of a new auditor in place of a retiring auditor which is as follows:

(a) **<u>Special notice</u>** ***-*** For appointing a person other than the retiring auditor or to provide that the retiring auditor shall not be re-appointed, a special notice of such a resolution should be given to the company at least fourteen days before the meeting.

(b) **<u>Copy of notice to retiring auditor</u> -**The company shall send a copy of the notice of such a resolution to the retiring auditor.

(c) **<u>Provisions of section 190(1)</u> -** As required under section 190(1), the company shall also give its members notice of such resolution (requiring special notice) at least seven days before the meeting in the same manner as it gives notice of the meeting. However, if this is not practicable, the company can give such a notice either by advertisement in a newspaper having an appropriate circulation or in any other mode prescribed by the articles at least seven days before the date of meeting.

(d) **Right to make representations -** The retiring auditor has a right to make representations in writing to the company, not exceeding a reasonable length and request for their notification to the members.

(e) **Copy of representation to every member –** The company, on receipt of representations, shall mention the fact of representations being made in the notice of the meeting and send a copy thereof to every member of the company to whom the notice of the meeting is sent. However, if the representations are not sent because of the default of the company or late receipt, these may be read out during the meeting.

(f) **Exemption by the Central Government -** If the Central Government, on the application either of the company or of any other aggrieved person, is satisfied that the auditor is securing needless publicity of a defamatory matter, it can exempt the company from sending the copy of representations to the members or reading them out at the general meeting.

(g) **Other rights of retiring auditor -** Besides the rights mentioned above viz. right to receive notice of the resolution, right to make written representations to the company, right to get his representations circulated or read out at the meeting, the retiring auditor also has a right to be heard at the meeting.

(h) **Passing of resolution -**The general meeting may by passing an ordinary resolution [or special resolution in case of appointment under section 224(A)] remove such an auditor.

(i) **Duty of incoming auditor -** The Institute of Chartered Accountants of India (ICAI) has advised that where an auditor, though willing for reappointment has not been reappointed, he shall file with the ICAI a copy of representations which he may have sent to the company for circulation amongst shareholders. The incoming auditor should before accepting the appointment obtain a copy of such communication from the company and consider it before accepting the appointment.

Penalty for non-compliance with section 225

According to section 232 of the Companies Act, 1956, if default is made by a company in complying with any of the provisions contained in section 225, the company and every officer of the company who is in default, shall be punishable with fine which may extend up to five thousand rupees.

RIGHTS & DUTIES OF A COMPANY AUDITOR

RIGHTS / POWERS OF AN AUDITOR

There are various rights conferred upon the auditor by the Companies Act, 1956. The principal rights, except those in case of removal of the auditor, are mentioned below:

(i) <u>Right of access at all times to books, accounts and vouchers of the company</u>

- Section 227(1) confers upon the auditor right of access at all times to books, accounts and vouchers of the company, whether kept at the head office of the company or elsewhere.
- The term *vouchers* includes all documents, correspondences, agreements and evidences which serve to support any entry in the financial statements.
- The term *books* include all the books, which affect or may affect the financial statements. It includes financial, statutory and statistical books, cost records, stock books, minutes books of general meetings, directors' minutes books, etc.
- The auditor can exercise this right *at all times* which implies normal business hours on any working day.

(ii) <u>Right to receive notice and to attend general meetings</u>

- According to section 231, the auditor has a right to receive all notices and other communications relating to any general meeting of a company as are sent to the members of the company.
- The auditor can attend any general meeting like a member. However, he can speak only on the matters, which concern him as an auditor.

(iii) <u>Right to obtain information and explanations</u>

- Section 227(1) empowers the auditor to call for any explanation or information from the employees and officers including managing dirertor and other directors of the company, which he thinks is relevant for the purpose of audit and proper discharge of his duties.
- In case any information or explanation is not given to him, he should mention this fact in his audit report.

(iv) <u>Right to visit branches</u>

- Section 228(2) states that the auditor has a right to visit branch offices of the company and has access to the books, accounts and vouchers maintained thereat.
- The only exception is in case of foreign branches of a banking company. In such cases, it would be sufficient if the auditor of the company is allowed access to such copies of, and extracts from, the books and accounts of the branch as have been transmitted to the principal office of the company in India.

(v) <u>Right to sign audit report</u>

- Section 229 has laid down that only the person appointed as auditor of the company can sign the auditor's report or sign or authenticate any other document (for example, certain contents of statutory report) of the company as required by law to be signed or authenticated by the auditor.

- In case a partnership firm is appointed as an auditor, then only a partner of the firm practising in India can do so.

(vi) <u>Right to receive remuneration</u>

- The auditor has a right to receive remuneration as per the provisions of section 224(8) of the Act.
- This right arises only on the completion of audit work. However, he can recover it on a progressive basis in accordance with a resolution passed by the general meeting.

(vii) <u>Right to lien</u>

- Section 209 of the Companies Act, 1956 provides that books of account shall be maintained at the company's registered office unless board of directors decides to keep them at another place in India. The company must inform the Registrar of Companies, if the board so decides.
- In the light of this provision, one can conclude that the auditor can exercise his *right to lien* on *books of account,* if the board has authorised him to possess such records.
- The Institute of Chartered Accountants of England and Wales has expressed a similar view. According to the Counsel of ICAEW the auditor can exercise his right to lien if -
- Books of account/ documents have been entrusted to the auditor by the board of directors i.e., he has not received them through irregular or illegal means.
- He has done work on the documents assigned to him.
- The documents retained are connected with the work on which fees have not been paid.

Thus, law has made the exercise of right to lien on books of account by the auditor difficult. But, the auditor, as per AAS-3, has an uncontestable lien on his working papers. These have been regarded as his property by the Standard.

The abovementioned rights are absolute rights and cannot be limited, abridged or curtailed in any way because they enable the auditor to discharge his duties effectively. Any resolution limiting the powers of the auditor or a provision to this effect in the articles of association will be void. In Newton v. Birmingham Srnall Arms Co. (1895), it was held that any regulation which preclude the auditors from availing themselves of all the information to which they are entitled, is inconsistent with the Act.

<u>DUTIES OF AN AUDITOR</u>

The duties of an auditor under the Companies Act can be discussed under the following heads:

- Duty to report [section 227(2) and (3)]
- Duty to enquire [section 227(1A)]

- Duty to make statements on additional matters specified by the Central Government [section 227(4A)]
- Other statutory duties.

DUTY TO REPORT

Section 227(2) requires the auditor to make a report to the members of the company on the accounts examined by him and on every balance sheet and profit and Loss account and on every document declared to be a part of or annexed to the balance sheet or profit and loss account laid before the company in the general meeting during his tenure of office.

Further, section 227(2) and (3) have laid down that the auditor's report shall state certain matters such as:

(i) Whether, in his opinion and to the best of his information and explanations given to him,

  (a) The accounts of the company give information required by the Act manner so required, and

  (b) The balance sheet gives a true and fair view of the state of affairs and profit and loss account represents a true and fair view of profit or loss of the financial year.

(ii) Whether he has obtained all the information and explanations, required for the purpose of his audit.

(iii) Whether, in his opinion, proper books of account as required by law have been maintained and proper returns adequate for the purpose of audit have been received from the branches not visited by him.

(iv) Whether the report on the accounts of any branch office audited under sec. 228 by a person other than the company's auditor has been forwarded to him as required by section 228(3) and how has he dealt with the same in preparing the auditor's report.

(v) Whether the company's financial statements are in agreement with the books of account and returns.

(vi) Whether, in his opinion, the profit and loss account and balance sheet comply with the accounting standards referred to in sub-section (3C) of section 211.

(vii) Whether any director is disqualified from being appointed as director under section 274(1)(g). (The auditor should obtain representations from individual directors to this regard),

(viii) Whether cess payable under section 441A has been paid, if not the details of amount of cess not so paid.

It should state in **thick** type or in *italics,* the observations or comments of the auditors, which have any adverse effect on the functioning of the company.

The above statement of facts [(ii), (iv), (v), (vii) and (viii)] and statement of opinions [(i), (iii) and (vi)] should be stated expressly, clearly and unambiguously in the auditor's report.

DUTY TO ENQUIRE

Section 227(1A) requires the auditor to make enquiries into six specified matters. This section has been inserted into the Act in order to ensure that the management does not siphon-off money of the shareholders for personal benefit.

Accordingly, the auditor has to enquire into the following matters:

(i) Whether loans and advances made 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 is required to ascertain the legality of the title of the security offered for loans and advances and should ensure that value of the security fully covers the amount of the loan or advance.

The question as to *terms* [i.e., security offered, the interest charged and terms of repayment] on which such loans and advances have been made, is prejudicial to the interests of the company or not, is a matter of professional judgment of the auditor.

Example - XYZ Co. appoints 'Mr. A as its CEO. He is very well-known in the industry for his leadership qualities and management skills. Mr. A joins the company on the condition that besides salary and other perks, the company would give him an interest- free fully secured housing loan of Rs. 10 lakhs repayable over a period of 10 years. The comparable market rate of interest for such a loan is 8%. If Mr. A is capable of giving a new thrust to the operations of the company and the profitability of the company is likely to increase under his leadership, the auditor may not consider this loan as prejudicial.

(ii) Whether transactions of the company, which are represented merely by book entries, are not prejudicial to the interests of the company

The auditor should enquire whether transactions that are represented by book entries, in fact, have taken place, and are not prejudicial to the interests of the company.

Example 1 - The books recorded payment for purchases made in cash. In reality no such transaction has taken place. The auditor's report should mention this fact. *Example 2 -* Books of account of Flintos Ltd. showed that it obtained deposits from a friendly source just before the year-end. The effect of the transaction is to increase the apparent size of deposits in the balance sheet. In the following financial year, these deposits are re-deposited with the same source. Thus, these transactions were only book entries and prejudicial to the interests of the company.

(iii) In case of companies other than investment companies or banking companies, whether assets of the company such as shares, debentures and other securities have been sold at a price less than that at which they were purchased by the company

The auditor is required to enquire in all cases where shares, debentures and other securities have been sold at a price less than their cost. The investment companies and banking companies are outside the ambit of the clause.

Example :The books of a trading firm, PQR Ltd., for the year 1999-2000 showed sale of 10,000 shares of XYZ Co. held by it at a loss of Rs. 80,000. Management actually intended to establish losses to reduce tax liability through this sale. The auditor must enquire and mention this fact in his report.

(iv) Whether loans and advances made by the company have been shown as deposits

Loans and advances made to individuals or private concerns by the company and deposits with banks, public authorities, etc. are both shown as assets in the balance sheet of a company. The term 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 or for the purpose of earning interest from the party who customarily accepts deposits. Thus, the degree of risk associated with its repayment / encashment is far less than loans and advances. The auditor is required to enquire into the fact whether loans and advances have been shown as deposits and not *vice versa.*

(v) Whether personal expenses have been charged to revenue account

At times, managers or employees of the company charge to the company expenses incurred by them which, in fact, should have been borne by them. This is done with an intention to siphon-off the funds of the company. Some of the common examples of such situations are: charging expenses incurred in throwing a party to friends and relatives to the company as entertainment expenses and giving 'personal trips' the guise of `official trips'. The auditor should report on such expenses. It is important to note that personal expenses of the employees and directors of the company such as medical expenses, leave travel re-imbursement, etc. which are borne by company pursuant to the terms of appointment and normal facilities such as rent-free houses and pantry facility, do not amount to personal expenses.

(vi) If shares have been allotted for cash, whether the cash has been actually received and, if not received, whether the position has been correctly reflected in the balance sheet in a manner that is correct and not misleading

The auditor should examine as to whether cash has actually been received against the shares allotted for cash. For shares allotted for consideration other than cash, the auditor should ensure their adequate and correct disclosure in account books and balance sheet. As per the decision in *Spargo's* case, shares allotted against a debt payable by the company may also be included under the expression 'shares allotted for cash',

The auditor is not required to make a report on above-mentioned matters. But if his enquiry has revealed anything serious or if he is not satisfied with the results of enquiry on any matter, he should mention this specifically in his report.

Duty to make statements on additional matters specified by the Central Government

Section 227(4A) empowers the Central Government to issue suitable instructions to auditors to report on certain additional matters in the audit report of classes of companies notified. Depending upon the circumstances, the Central Government may or may not consult ICAI. In pursuance of the powers conferred by section 227(4A), the Central Government in consultation with ICAI has issued CARO 2003 [The Companies (Auditor's Report) Order, 2003] that requires the auditor to make statements in terms of provisions stated therein. It has superseded MAOCARO 1988 [Manufacturing and other Companies (Auditor's Report) Order, 1988]

Other Statutory duties

(i) **Duty to certify the statements contained in prospectus** - Section 56(1) lays down that the matters and reports stated in Schedule II to the Companies Act must be included in the prospectus. The auditor has to prepare certain reports to give financial information as required under this Schedule. Examples of such reports include reports on company's profits and losses and on assets and liabilities and on rates of dividends paid in respect of each class of shares for each of the last five financial years immediately preceding the issue of prospectus.

(ii) **Duty to certify the contents of statutory report** - According to section 165(4), the auditor is required to certify certain contents of statutory report viz., relating to the shares allotted by the company, cash received in respect of such shares and receipts and payments of the company.

(iii) **Duty to report under voluntary winding up** - As per the requirements of section 488(2), in cases where it is proposed to wind up company voluntarily, the directors are required to make a declaration of solvency. A copy of the latest audit report should accompany such a declaration.

(iv) **Duty of auditors to attend Audit Committee meetings** - Section 292A requires public limited companies with paid-up capital of Rs. 5 crores or more to set up an Audit Committee of the board of directors for better corporate governance. This section has laid down a duty on the auditor of the company to attend and participate at meetings of the Audit Committee, but he shall not have the right to vote. Further, it also requires the Audit Committee to have discussions with the auditors periodically about internal control system and the shape of audit including his observations.

POSITION OF AN AUDITOR

The auditor has a fiduciary relationship *vis-a-vis* the shareholders. Besides the Companies Act, his duties have been established by pronouncements of learned judges in general case laws. Some important facts with regards to his status are given below :

(i) **Auditor is not an adviser -** An auditor is not an adviser. LINDLEY LJ observed in London & General Bank case, "It is no part of an auditor's duty to give advice, either to directors or shareholders, as to what they ought to do.... It is nothing to him whether the business of a company is being conducted prudently or imprudently, profitably or unprofitably; it is nothing to him whether the dividends are properly or improperly declared, provided he discharges his own duty to shareholders his business is to ascertain and state the true financial position of the company at the time of the audit….”Thus, rendering advice is no part of an auditor's duty. A financial audit is simply a systematic and independent examination of evidence for the purpose of ascertaining whether the balance sheet gives a true and fair view of state of affairs of a business and the profit & loss account reveals true and fair view of its working results. The auditor communicates his opinion on the financial statements through audit report. If the auditor's advice is sought by the board of directors, he may advice them on important accounting and financial matters. But it should not have any connection with the audit work and this should be stated explicitly in every communication. If the auditor wants to suggest improvements in internal control system, he should do it through a 'Management Letter'. His duties have been clearly stated in the Companies Act, 1956.

(ii) **An auditor is not an insurer -** An insurer, under a contract, compensates the insured for any loss or damage to the subject-matter of insurance. But as remarked by LINDLEY LJ in London and General Bank case, "an auditor is not an insurer." He does not guarantee that the books of the company show the true position of its affairs or that its balance sheet is accurate according to the books. In other words, he does not offer complete protection against frauds and errors.

He is only supposed to exercise reasonable skill, care and caution in the discharge of his duty. His duty with regards to detection and prevention of frauds has already been explained in chapter one. Further, in order to ensure that the auditor discharges his duty according to requisite professional standards of reasonable care and skill, the Companies Act has clearly laid down duties of the auditor in section 227. In case of negligence, the auditor can be held liable under the common law and also the Act.

(iii) **An auditor is to give information, not means of information** - Lord JUSTICE LINDLEY observed in London and General Bank case, "A person whose duty is to convey information to others, does not discharge that duty by simply giving them so much information as is calculated to induce them, or some of them to ask for more. Information and means of information are by no means equivalent terms.” Thus, according to him, an auditor should give information in a manner, so as to enable the user of his report to form an opinion on financial statements of the entity. `Information' is something which is complete and is sufficient to answer any queries or clear any doubts in the mind of the user of financial statements. On the other hand, 'means to information' given in an audit report arouses enquiry and a user would not be able to form an opinion about truthfulness and fairness of financial statements. The whole purpose of audit is lost in such a situation. Hence, an auditor should give information and not means of information. The Companies Act, 1956 has laid down clearly the reporting requirements for an auditor under section 227 to ensure that he gives all material information in his audit report.

(iv) **An auditor as an agent -** An auditor is appointed by shareholders of a company. He should safeguard their interest. Hence, he may be referred to as an agent of the shareholders. The extent to which an auditor can be regarded as an agent of the shareholders was considered in *a* Spackman v. Evans [1868]. The Court held that the auditors may well be regarded as agent of the members appointed to carry out duties laid-down by the statute and by a particular company's articles. However, this status would be confined only to the purposes of audit.

(v) **Auditor is a watch dog and not a blood-hound.**

BRANCH AUDIT

Section 228 of the Act deals with audit of accounts of branch office of a company This section applies to every kind of company that has a branch office. The important points with regard to branch audit are summarised below:

(j) **Who can be appointed as branch auditor?**

The audit of accounts of a branch can be done either by (i) the company's auditor or by any other person who is qualified to act as the company's auditor. The shareholders in a general meeting would decide as to whether the books of account of a branch should be audited by (i) or (ii). The general meeting may authorise board of directors to appoint the branch auditor in consultation with the auditor of the company. If a branch is situated outside India, a person who is duly qualified to act as an auditor of the branch in accordance with laws of that country can also be appointed as auditor of the branch.

(ii) **Rights of company's auditor in relation to branch audit**

The company auditor has a right to visit the branch office even if a different auditor is auditing the accounts of branch and also has a right of access at all times to books, accounts and vouchers of the company maintained at branch office. However, auditor of a banking company does not have the right to visit foreign branches of the company.

(iii) **Powers and duties of branch auditor**

The branch auditor has the same powers and duties in respect of audit of the accounts of the branch office as the company's auditor has for the audit of company's accounts.

(iv) **Branch audit report is to be forwarded to statutory auditor**

The branch auditor shall prepare a report on the books and accounts of the branch office examined by him and forward the same to the company's auditor. The company's auditor, while preparing his audit report, will deal with the branch audit report in the manner as he considers necessary.

(v) **Fixation of remuneration and other terms and conditions of appointment of branch auditor**

The shareholders in a general meeting or board of directors, when authorised by general meeting, have the power to fix remuneration and other terms and conditions of appointment of branch auditor.

(vi) <u>Exemption from branch audit</u>

Section 228(4) has empowered the Central Government to exempt any branch office from the requirement of branch audit. In pursuance of these powers, the Central Government has framed the Companies (Branch Audit Exemption) Rules, 1961. These rules provide exemption on the following grounds:

(a) A branch office of a company carrying on manufacturing, processing or trading activity is exempt if the average quantum of activity is rupees two lakhs or two per cent of average of the total turnover of the company, whichever is higher.

(b) The company has made arrangements for the audit of accounts of the branch office by a person otherwise qualified for appointment as branch auditor, even though he is an employee of the company. An employee of a company, who is required to audit books of a branch office under these rules, should be a Chartered Accountant within the meaning of Chartered Accountants Act, 1949.

(c) The cost of employing branch auditor does not commensurate with the nature and quantum of activity carried on at the branch office.

(d) In case of a company carrying on activities other than those of manufacturing or processing or trading, even an arrangement for the scrutiny and checking of the books of account of a branch office would be sufficient provided the arrangements are satisfactory and checking and scrutiny is done at regular intervals by a responsible person who is competent to do so.

(vii) <u>Auditor's duty in case of branch exemption</u>

He should state in his audit report that branch office is exempt by virtue of quantum of activity or an exemption granted by the Central Government on specific application.

(viii) <u>Coordination between auditors</u>

On the basis of Auditing and Assurance Standard (AAS) 10, Using the Work of Another Auditor, the following points with regard to this can be made:

(a) The company auditor will not be responsible for the work of the branch auditor

(b) The principal auditor should take appropriate steps to ensure required liaison with the branch auditor.

(c) In order to ensure proper coordination in the overall audit work, the auditor of the company can make such enquiries and seek information from the branch auditor as he thinks necessary for discharging his duties. The auditor may require the branch auditor to answer a detailed questionnaire regarding matters on which he needs information or clarification and these should be responded on a timely basis.

AUDITOR'S REPORT

THE AUDIT REPORT : AS A MEANS OF COMMUNICATION

The main objective of an independent financial audit is the expression of an opinion regarding the truthfulness and fairness of presentation of the financial statements. This opinion is communicated to the owners /members through the medium of audit report.

CERTIFICATE VS. REPORT

Audit Report and Audit Certificate

Basis	Audit Report	Audit certificate
Meaning	It is a formal statement usually made after an inquiry, examination or review of specified matters under report and includes the reporting auditor's opinion thereon	It is a written confirmation of the accuracy of the facts stated therein and does not involve estimate or opinion
Nature	It is an opinion on reliability of the financial statements prepared by the entity	It gives guarantee of absolute accuracy and correctness of the information contained therein e.g. statement contained in prospectus are to be certified by the auditor
Responsibility of the auditor	The auditor is responsible to render his opinion with reasonable care and skill	The auditor is responsible for absolute accuracy of facts stated therein

Elements of audit report

The audit report should describe the scope and nature of the audit work and the opinion of the auditor. Besides this, there are various basic elements which should be there in an audit report. Important elements of an audit report, as listed by AAS-28, are described below:

(i) **Title** - An appropriate title such **as Auditor's Report,** helps the readers to identify the report and to distinguish it from the reports issued by others.

(ii) **Addressee -** The report should be addressed to the client or appointing authority. In case of a limited company, the report should be addressed to the shareholders.

(iii) **Introductory paragraph-** The introductory paragraph should identify the financial statements which have been audited (typically the balance sheet, profit and loss account and cash flow statement) and it also indicates that the statements are management's not the auditor's responsibility. The independent auditor is responsible only for expressing an opinion on the financial statements.

(iv) **Scope paragraph -** The scope paragraph should state that the audit was conducted in accordance with auditing standards generally accepted in India and describes what the auditor did in the audit. The description identifies several limitations of an audit. These include

- The reasonable (not absolute) assurance;
- The discovery of material (not all) misstatements,
- Reliance on test basis for audit examination; and
- Reliance on judgment for assessing adequacy of accounting principles and assessing estimates.

(v) **Opinion paragraph -** The opinion paragraph should make a reference to financial reporting framework being used by the entity to prepare the financial statements and whether the financial statements present a true and fair view of all material matters in accordance with the financial reporting framework being used. It should also state whether the financial statements comply with statutory requirements, if any.

(vi) **Date of the report -** It is the date on which the audit report is signed.

(vii) **Place of the signature -** The report should name a specific location, which is generally the city in which the auditor maintains his office.

(viii) **Auditor's signature -** An audit report should be signed by the auditor in his personal name and in case of a firm being appointed, in the name of audit firm also. Membership number assigned by the Institute of Chartered Accountants of India should also be mentioned.

Audit report of a limited company

Section 227 of the Companies Act, 1956 has laid down reporting requirements for the auditor. These can be divided into three parts:

- Duty to report
- Duty to enquire
- Duty to report on additional matters

(A) **Duty to report** - Section 227(2) of the Act requires the auditor to give his report to the members of the company on :

(a) Accounts examined by him;

(b) Every balance sheet and profit and loss account laid before a general meeting during his tenure; and

(c) Every document that is a 'part of' or 'annexed to' such balance sheet and profit and loss account. It should be noted that the auditor's report covers all documents which are 'annexed to' the balance sheet such as list of investments and particulars required by section 372(9). It, however, does not cover documents which are 'attached to' the balance sheet, for example, directors' report. Besides above, the matters on which an auditor has a duty to report under section 227(3) can broadly be divided in two categories:

- Statements of fact
- Opinions

(i) The statements of fact would relate to:

(a) **<u>Information and explanation</u>** *-* Whether he had obtained all the information and explanations, which to the best of his knowledge and belief were necessary for the purpose of his audit.

(b) **<u>Branch auditor's report</u>-** Whether the report on the accounts of any branch office audited under section 228 by a person other than the company's auditor has been forwarded to him as required under section 228(3)(c) and how he has dealt with the same in his report.

(c) **<u>Financial statements and books of account</u>** *-* Whether the company's balance sheet and profit and loss account dealt with by the report are in agreement with books of account and returns.

(d) **<u>Director's disqualification</u>-** Whether any director is disqualified from being appointed as director under clause (g) of sub-section (1) of section 274.

(e) **<u>Cess</u>** *-* Whether cess payable under section 441 A has been paid, if not, the details of the amount of cess not so paid.

(ii) The auditor is required to express his opinion as to the following:

(a) **<u>Proper books of account</u>** *-* Whether proper books of account as required by law have been kept by the company so far as it appears from the examination of the books and proper returns adequate for the purposes of audit have been received from branches not visited by him.

(b) **<u>Accounting standards</u>** *-* Whether the profit and loss account and balance sheet complied with the accounting standards referred to in sub-section (3C) of section 211*.*

(c) **<u>True and fair view</u>** *-* Whether the accounts give a true and fair view, in the case of the balance sheet of the state of the company's affairs, and in the case of the profit and loss account, of the profit or loss for the year.

The auditor, in his report, should highlight in **thick** type or in *italics* those observations or comments which have any adverse effect on the functioning of the company.

(B) **<u>Duty to enquire</u>**

Section 227(1A) requires the auditor to enquire into following

(a) 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.

(b) Whether transactions of the company which are represented merely by book entries are not prejudicial to the interests of the company.

(c) Whether shares, debentures and other securities have been sold at a price less than their cost. The investment companies and banking companies are outside the ambit of this reporting requirement.

(d) Whether loans arid advances made by the company have been shown as deposits.

(e) Whether personal expenses have been charged to revenue account.

(f) Whether cash has actually been received against the shares allotted for cash. If shares are allotted for consideration other than cash, the auditor should ensure their adequate and correct disclosure in account books and balance sheet.

The auditor is not required to report on these matters unless he has any special comments to make on any of the items mentioned above. He may consider to highlight comments which have any adverse effect on the functioning of the company, in **thick** type or *in italics.'*

(C) <u>Duty to report on additional matters</u>

Section 227(4A) has empowered the Central Government to issue suitable instructions to auditors. According to it, the central Government may, by general or special order, direct that, in case of such class or description of companies as may be specified in the order, the auditor's report shall also include a statement on such matters as may be specified therein. The central govt. may or may not consult the ICAI. In pursuance of the powers conferred by section 227(4A), the Central Government in consultation with ICAI has issued CARO, 2003. which requires the auditor to make a statement in terms of provisions stated in it.

Auditor's Signature	Signature (Name of the member signing the audit report)
Place	Delhi (Designation)
Date of the Report	15th June, 2003 (Membership number)

<u>Types of audit report</u>

Based on the kind of opinion expressed by the auditor, the audit report can be classified into five types —

(a) Standard unqualified report

- Unqualified report with an 'emphasis of matter' paragraph
- Qualified report
- Disclaimer of opinion report
- Adverse report

The last four types of audit reports are termed together as **modified reports.** Auditing and Assurance Standard (AAS) 28, The Auditors Report on Financial

Statements, states, "An auditor's report is considered to be **modified** when it includes :

a. Matters that do not affect the auditor's opinion
   - Emphasis of matter

b. Matters that do affect the auditor's opinion
   - Qualified opinion
   - Disclaimer of opinion
   - Adverse opinion."

(i) <u>Standard unqualified report or clean report</u>

The most common type of audit report is the standard unqualified audit report. It is issued when the following conditions are met:

(a) All financial statements give a true and fair view in accordance with the financial reporting framework used for the preparation and presentation of the financial statements;

(b) The financial statements have been prepared in accordance with the generally accepted accounting principles;

(c) The financial statements comply with relevant statutory requirements and , regulations; and

(d) Disclosures are adequate and statutory requirements with regard to them have been adhered to.

In case of a limited company, thus, if the auditor makes various statutory affirmations contained in section 227 without any reservation, he is said to have issued an unqualified report or clean report. An illustrative example of such a report is given :n Figure 1.1

(ii) <u>Unqualified report with an 'emphasis of matter' paragraph</u>

In certain cases, auditor may attach a paragraph to an unqualified opinion to put emphasis on a matter regarding financial statements due to its importance. Such a matter is, generally, included in a note to the financial statements which discusses it in greater details. 'Emphasis of matter' paragraph does not change the nature of the audit report as it relates to a matter that does not affect the auditor's opinion. Examples of situation in which an auditor introduces 'Emphasis of matter' paragraph are given below —

- Going concern doubt
- Significant uncertainty

(a) **<u>Going concern doubt</u> -** In every audit, the auditor has a responsibility to evaluate whether there is substantial doubt about the client's ability to continue as a going concern for up to one year following the balance sheet date.

If doubt about going concern assumption remains, the auditor case examines the adequacy of related disclosures in financial statements. These disclosures might include the principal conditions causing going concern doubt such as negative working capital, loss of a patent, etc along with management's plan of recovery from such a situation. In such cases, the auditor may add an emphasis of matter paragraph preceding the opinion paragraph and should categorically state in his report that he has expressed an unqualified opinion. Figure 1.2 provides an example of such a report.

FIGURE 1.2

Explanatory Paragraph Because Of Going Concern Doubt

	Auditor's report (Same introductory, scope paragraph as of standard unqualified report)
Emphasis of matter Paragraph	Without qualifying our opinion, we draw attention to Note 5 of Schedule III to the financial statements. The company has incurred a substantial operating loss of Rs. 10,00,000 and there is significant reduction in working capital of Rs. 6,00,000. These factors raise significant doubt about its capacity to continue as a going concern. In our opinion……..(remaining words similar to opinion paragraph of standard unqualified report)

(b) **<u>Significant Uncertainty</u>** ***-*** An uncertainty involves a situation that is dependent on the outcome of some future event that is not capable of reasonable estimation at the date of the auditor 's report such as court's decision on pending litigation violation of one or more restrictive covenants contained in loan agreement and realizable value of a significant receivable. The auditor in such situations may choose to bring the financial statement user's attention to the matter by adding a paragraph to the unqualified audit report. Figure 1.3 is an illustration of such a situation.

FIGURE 1.3

Explanatory Paragraph Because Of Significant Uncertainty

	Auditor's report (Same introductory, scope paragraph as of standard unqualified report)
Emphasis of matter Paragraph	Without qualifying our report, we draw attention to Note 3 of Schedule 1 to the financial statements. PQR Ltd., a subsidiary of the company is currently under liquidation. The liquidators of PQR Ltd. Have filed a suit asserting some claims against the company. The ultimate outcome of the litigation cannot

	be determined and hence, no provision for any liability has been recognised in accompanying consolidated financial statements. In our opinion…..(same as opinion paragraph of a standard unqualified report)

(iii) **Qualified audit report -** Qualified audit report is a report wherein the auditor has expressed a qualified opinion, that is to say, an opinion subject to certain reservations.

Important aspects in relation to qualifications in an audit report are mentioned below—

- The auditor should give a qualified opinion when the subject-matter of qualification is not highly material and pervasive and he believes that the overall financial statements give a true and fair view.
- A qualification should be preceded by the word 'subject to' or 'except that' to make it clear that the matter is of exceptional nature.
- The audit report should quantify the effect of individual qualifications and also the total effect of all qualifications on the financial statements. If precise quantification is not possible the auditor can use estimates made by the management after applying proper audit tests. The report should clearly mention the fact of reliance on such figures.
- The auditor shall state the reasons for his qualification.
- In case of a limited company, if any of the statutory affirmations in section 227(2) and section 227(3) are answered in negative or with qualification by the auditor, the audit report would be termed as a 'qualified audit report'.
- Qualifications which deal with matters, which have an adverse effect on the functioning of the company should be in **thick type** or in *italics.*

A qualified report can result from :

- Scope limitation
- Disagreement with management with regard to departure from generally accepted accounting principles or adequacy of disclosure

(a) **Scope limitation -** When an auditor is not able to gather sufficient appropriate evidence to support a financial assertion in financial statements i.e., there is a scope limitation, the auditor should either qualify or disclaim an opinion.

Scope limitations are sometimes client-imposed. For example, management may not permit the auditor to confirm some accounts receivables or may deny visit to client's premises. Scope limitations may also be imposed by circumstances. For example, the auditors may be unable to observe the taking of physical inventory because they were engaged by the client after year end; or the client's legal counsel may be unable to respond to the auditor's inquiry. In such situations, the auditor may or may not be able to obtain the necessary evidence by means of alternate auditing procedures. If he is unable to obtain sufficient appropriate evidence to support an unqualified opinion from these procedures the auditor, depending upon the materiality and pervasiveness, may issue a qualified report or may give a disclaimer of opinion.

(b) .... <u>Disagreement with management</u> - If there is disagreement with management with regard to a material departure from generally accepted accounting principles or adequacy of disclosure, the auditor may decide to issue a qualified or an adverse report. Materiality and pervasiveness is the criteria used in deciding among these alternatives.

(iv) <u>Disclaimer of opinion</u> ***-*** The auditor issues a disclaimer of opinion if the subject matter involved is material and pervasive and he is unable to obtain sufficient appropriate evidence to express an opinion on it. A disclaimer can result because material and pervasive uncertainties could not be resolved, there is going-concern doubt or there is a material limitation on the scope of the audit.

The uncertainty or the ability of an entity should be such as to make it difficult to determine whether assets should be valued at going-concern or liquidation values.

(v) <u>Adverse report</u> ***-*** When the auditor is of the opinion that the effect of disagreement with the management is material and pervasive to the financial statements, he gives an adverse report. The auditor must, categorically, state that the financial statements do not give a true and fair view.

<u>SPECIAL AUDIT</u>

(i) <u>Power of the Central Government to order special audit</u>

As per section 233A of the Act, the Central Government has the power to order a special audit of the company's accounts for a specified period without giving the company or its management an opportunity of being heard.

(ii) <u>Circumstances under which this power will be exercised</u>

The Central government may order a special audit under any one of the following circumstances

(i) The affairs of any company are not being managed in accordance with sound business principles or prudent commercial practices; or

(ii) The company is being managed in a manner likely to cause serious injury or damage to the interests of the trade, industry or business to which it pertains; or

(iii) The financial position of the company is such as to endanger its solvency.

(iii) <u>Who can be appointed as a special auditor</u>

The Central Government may appoint either the company's auditor himself or any other chartered accountant as defined in section 2(1) of the Chartered Accountants Act, 1949, whether he is in practice or not, as special auditor.

(iv) <u>Remuneration of the special auditor and other expenses</u>

The remuneration of the special auditor is determined by the Central Government but is paid by the company along with other expenses incidental to the audit.

(v) <u>Powers & duties of the special auditor</u>

In addition to the powers given to company auditor under section 227, the special auditor also has the power/right to call for any information from a person, who has been directed by the Central Government under an order, to furnish information that is required by the special auditor in connection with the special audit. In case of default by such person in providing information, he shall be punishable with fine, which may extend up to five thousand rupees.

The special auditor has the same duties as a company auditor under section 227. However, there are a couple of differences. Firstly, instead of making his report to the members of the company, he submits it to the Central Government. The second difference relates to the contents of special audit report. The auditor should include information on the matters required to be reported upon in the audit report under section 227 of the Act, as far as possible. Moreover, the special auditor's report should also include a statement on any other matter that may be referred to him by the Government.

(vi) <u>Receipt of report from the special auditor</u>

On receipt of the special auditor's report, the Central Government may take necessary action on the report. If no action is taken by the Central Government on the report, it shall send to the company, after four months of such receipt, either a copy of or extracts from the report with its comments thereon and require the company to circulate it amongst its members or to read it out at the next annual general meeting.

COST AUDIT

MEANING

Cost audit means an examination of cost records. It has been defined as ”the verification of the correctness of cost accounts and of adherence to the cost accounting plan”. Cost audit is undertaken with the broad objective of ascertaining whether cost present a true and fair view of the cost of production or manufactured products dealt with by the enterprise under audit.

PROVISIONS REGARDING COST AUDIT UNDER THE COMPANIES ACT, 1956

(i) <u>Maintenance and audit of cost accounts in certain cases</u>

The Companies (Amendment) Act, 1965 introduced two amendments to the Companies Act, 1956 relating to cost audit. These amendments incorporated clause (d) to sub-section (1) of sections 209 and 233B to section 233.

Section 209(1)(d) empowers the Central Government to make it compulsory in the case of specified classes of companies to maintain cost records. The Central Government, as per provisions incorporated under this sub-section, can require particulars relating to utilization of material or labour or other items of cost to be included in the cost records of a company (pertaining to any class of companies) engaged in production, processing, manufacturing or mining activities. In pursuance of these powers, the Central Government has from time to time prescribed rules regarding maintenance of cost accounting records separately for a number of industries.

Section 233B empowers the Central Government to order audit of cost accounts in certain cases. According to the provisions laid under section 233B, the Central Government may, if it feels necessary, by an order direct that an audit of the cost records kept by a company under section 209(1)(d) shall be conducted by a cost auditor within the meaning of the Cost and Works Accountants Act, 1959 in such a manner as may be specified in the order. If, however, the Central Government is of the opinion that sufficient number of cost accountants are not available for conducting the audit of cost accounts of companies, it may, by notification direct that for a specified period, chartered accountants having prescribed qualifications may also conduct the audit of cost accounts of companies. An audit conducted by a cost auditor under this section shall be in addition to the audit conducted by an auditor under section 224 of the Companies Act.

The provisions of section 233B shall also apply to the Indian business of a foreign company having an established place of business in India, as they apply to an Indian company.

(ii) <u>Qualifications of cost auditor</u>

Section 233B prescribes the qualification of a cost auditor. The cost audit can be conducted by—

(a) A cost accountant within the meaning of the Cost and Works Accountants Act, 1959.

(b) A firm of cost accountants, if all the partners of a firm are practicing cost accountants, and the firm itself has been constituted with the previous approval of the Central Government. The audit report, in this case, shall be signed by any one of the partners of the firm for and on behalf of the firm.

(c) A chartered accountant having prescribed qualifications, if the Central government is of the opinion that sufficient number of cost accountants are not available for conducting the audit of cost accounts of the Companies. However, it has to issue a notification with regards to this and has to specify period for which notification is applicable.

(iii) Disqualifications of cost auditor

The disqualifications of a cost auditor are listed below :

(a) A person cannot be appointed as a cost auditor of a company if he attracts
any of the disqualifications mentioned under section 226(3) and 226(4).

(b) A person appointed under section 224 as an independent financial auditor, shall not be appointed or reappointed for conducting the audit of the cost accounts of a company.

(c) A person who is an employee or a partner of the company auditor or an employee of any of the partners of a firm of chartered accountants which is appointed as the company's auditor under section 224.

(d) Internal auditor of the company cannot also be the cost auditor. As per notification issued by the Department of Company Affairs cost auditor should not be the internal auditor of a company for the period for which he is conducting the cost audit. The cost auditor is required to comment on the scope and performance of internal audit as per the provisions of the Cost Audit (Report) Rules, 2001. If the cost auditor is also the internal auditor, he would not be able to discharge his duties properly and dispassionately.

(iv) Appointment of cost auditor

The cost auditor is appointed by the board of directors of the company on receipt of the order of the Central Government. Such an appointment is made through a resolution passed either in the board's meeting or by circulation and is subject to the approval of the Central Government. Normally, prior occurrence of the Central Government is obtained before passing a resolution. The board of directors, before appointment of the auditor, shall obtain a certificate from the auditor to effect that the proposed appointment, if made, will be in accordance with the ceiling prescribed in the case of an auditor under section 224(1B).

(v) Powers of cost auditor

The cost auditor has the same powers regarding cost audit as an auditor of a company under section 227(1) (Refer to paragraph 10.1). However, if within one hundred and thirty five days of the end of financial year the company and its officers do not make available to the cost auditor such cost accounting records, statements and other books and papers as required for the cost audit, he has to intimate this to the Central Government within ten days after expiry of the aforesaid period.

(vi) Duties of cost auditor

The cost auditor has duties similar to those of the auditor appointed under section 224(1). However, he does not submit his report to the shareholders. He has to make his report to the Central Government in such form and within such time as may be prescribed. At the same time, he has to forward a copy of the report to the company.

(vii) <u>Cost audit report</u>

Section 233B of the Act has laid down the duties of the company on the receipt of the cost audit report and the rules regarding the cost audit report are prescribed by the Cost Audit (Report) Rules, 2001.

<u>THE COST AUDIT (REPORT) RULES, 2001</u>

The Central Government has framed the Cost Audit (Report) Rules, 2001 as to audit of cost accounts. The summary of the rules is given below:

(a) The company and every officer of the company shall make available within one hundred and thirty five days from the end of the financial year cost accounting records to the cost auditor for the purpose of cost audit. In case of default, he has to inform the Central Government within ten days after expiry of the aforesaid period of 135 days. The company and every officer of the company shall be liable to a fine upto Rs. 5,000 and in case of a continuing contravention with further fine upto Rs. 500 for every day after the first day during which period such contravention continues.

(b) The cost auditor has to report on certain matters in the audit report, viz:
   - Whether he has obtained all information and explanations necessary for the purpose of audit;
   - Whether proper cost accounting records have been kept;
   - Whether proper returns adequate for the purpose of cost audit have been received from branches not visited by him;
   - Whether books and records give the information required by the Companies Act in the manner so required;
   - Whether the cost statements as required are kept by the company;
   - Whether the company’s cost accounting records have been kept so as to give true and fair view of the cost of production, processing, manufacturing or mining activities and marketing of the product; and
   - Whether the cost statements as specified in the Annexures/Proforma of Schedules I to III as applicable to Cost Accounting (Record) Rules duly audited by him are kept in the company.

(c) The report should be sent to the Central Government and to the company, within 180 days from the end of the company's financial year to which the cost audit report relates. In case of failure to do so, the cost auditor would be liable to pay fine which may extend to five thousand rupees.

(d) The report should be submitted to the Central Government in the prescribed form in triplicate.

(e) The cost audit report is required to be accompanied by an annexure thereto containing prescribed information and data. A summary of all cost statements indicating unit cost of production, cost of sales, etc shall also be furnished to the Central Government by the cost auditor.

(f) The cost auditor shall give clarifications, if any, required by the Government on the cost audit report within thirty days of the receipt of the communication in this behalf. In case of failure to do so, he shall be liable for fine which may extend to five thousand rupees.

(g) If the cost auditor qualifies his report, he should indicate the extent to which he has qualified the report and the reasons therefore.

SECTION 233B: DUTY OF COMPANY

(a) As already mentioned, the auditor has to forward a copy of the cost audit report to the company. The company shall, within thirty days from the date of receipt of a copy of the report, furnish the Central Government with full information and explanations on every reservation or qualification contained in such a report.

(b) On receipt of the report and information and explanations furnished by the company, the Central Government may take appropriate action on the report. It may direct the company whose cost accounts have been audited under section 233B to circulate to its members, along of the annual general meeting to be held for the first time after submission of such report, the whole or such portion of the said report as it may specify in this behalf.

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