

PAPER – 3 : ADVANCED AUDITING

QUESTIONS

1. There is evidence that the public interest would be best served by the inclusion of fuller information about risks facing companies in audited financial statements. Doubts about the going-concern presumption must be detected and adequately disclosed in financial statements and auditors reports. You are required:
  - (a) to explain what you understand by the term 'going-concern basis' in relation to the preparation of financial statements.
  - (b) to describe the audit procedures necessary in order to gain sufficient audit evidence to be able to form an opinion on the going-concern status of a company.
  - (c) to list six factors which might cast doubt on the going-concern status of a company.
2. What is the responsibility of an auditor when he relies on the work performed by another expert, for forming and expressing his opinion on the financial statement? How should he evaluate the work of an expert?
3. As a Statutory Auditor, how would you deal with the following situations?
  - (i) During the course of a continuous audit of a limited company, the auditors detected that the Managing Director had committed a fraud involving a loss to the company. The Managing Director fully compensated the company, soon after detection and before the close of the year.  
How should the auditor deal with this situation in his report to the shareholders?
  - (ii) JKL Ltd., has shown in its Balance Sheet a cash balance of Rs.5,00,000 as against the normal cash balance of Rs.50,000 throughout the year. On further inquiry it is revealed that the said amount of Rs.5,00,000 was withdrawn in the last week and the balance has been continuously maintained till the date of audit. The examination also reveals that in spite of the cash balance of Rs.5,00,000 cash is drawn from the bank during this period for petty cash requirements.
4. List three situations where the auditor would be unlikely to use audit sampling techniques.
5. One of the recent developments in auditing has been consideration of audit risk, which in turn has influenced the way audits are carried out and the balance of work between the different sections of an audit. You are required
  - (a) to list and describe the factors you would consider in assessing the audit risk when you are planning the audit of the accounts of a manufacturing company, and the situations when you consider there will be high level of audit risk. Your answer should consider the following items in the accounts:
    - (i) tangible fixed assets;
    - (ii) stock;
    - (iii) trade debtors;
    - (iv) contingencies.
  - (b) Why consideration of audit risk has become an important factor for auditors to consider when planning and carrying out an audit?
6. The new audit trainee of your firm of auditors has asked you to advise him on the reliability of the following types of third party evidence:
  - (i) valuation of land and buildings by a valuer
  - (ii) the replies to a debtors' circularisation
  - (iii) the letter received from the bank.

- (a) Discuss the reliability of each of the three types of third party evidence listed in (I) to (iii) above and consider the accuracy of the valuations they provide.
  - (b) Describe the work you would carry out to check the independence, qualifications and experience of the valuer and the accuracy of the valuation.
  - (c) Describe the work you would perform in checking the bank reconciliations and that the balance on the bank accounts, as included in the financial statements, correct.
- 7.
  - (a) Explain the contents of reports under compilation engagement.
  - (b) What are the characteristic features of reporting in case of agreed-upon procedures?
- 8. What is your understanding about the term "Audit of Indirect Taxes"? Explain the steps involved in the Indirect Tax Audit.
- 9. What are the key functions of an energy auditor?
- 10. The Companies (Auditor's Report) Order, 2003 is applicable to specified category of Companies. Explain?
- 11. CARO, 2003 exempts private limited companies satisfying certain criteria from the applicability of the Order. In that context, explain the concept of paid-up capital and reserves, public deposits, loans outstanding and turnover.
- 12. Comment on the following in the context of schedules to the Chartered Accountants Act, 1949:
  - (a) A firm of Auditors of a Limited Company gives Power of Attorney to an employee Chartered Accountant to sign reports and financial statements of the company.
  - (b) A Chartered Accountant sends his report by Value Paid Postage (V.P.P.) to cover the audit fee payable without signing the report.
  - (c) A letter is sent by a Chartered Accountant to the Ministry of Finance inquiring whether a panel of Auditors is being maintained by the Ministry if so to include his name in the panel (Bio-data Enclosed).
- 13. What procedure an auditor is required to follow to verify the items while reporting under CARO, 2003 listed below:
  - (i) Statutory dues not deposited
  - (ii) Repayment of Dues
- 14. Write notes on the following:
  - (a) Disclosure of a guarantee furnished as a security or cover for an existing liability which is already recorded in books.
  - (b) Disclosure of a guarantee furnished as security or cover for a contingent liability.
  - (c) Disclosure of guarantee in the Company's Book receiving a guarantee.
- 15. Write short notes on the following
  - (a) Audit Committee
  - (b) Environmental Audit
- 16. How would you verify the following while auditing the books of account of the branch of a General Insurance Company?
  - (a) Premium received
  - (b) Claims paid
  - (c) Commission paid and received
  - (d) Balance outstanding against agents.
- 17. Write Short Notes:
  - (a) Auditor's Responsibilities regarding comparatives
  - (b) Financial indicators in case of Going Concern Assumption

- (c) Consolidated Financial Statements
  - (d) Divisible Profits
  - (e) Suspension of Capitalisation of Borrowing Costs
18. You have been appointed Management Auditor of a large engineering company suffering from a working capital crunch. Discuss broadly the action plan which you would recommend to their management for overcoming their problem.

#### SUGGESTED ANSWERS

1. (a) When financial statements are prepared on a going concern basis then:
- (i) Assets are recorded on the basis that the company will be able to realise or recover them at or above recorded amounts in the normal course of business.
  - (ii) Liabilities are recognised and recorded on the basis that they will be discharged in the normal course of business.
- AS 1, "Disclosure of Accounting Policies" defines the going-concern concept as meaning that the enterprise will continue in operational existence for the foreseeable future. This means that the financial statements are prepared on the assumption that there is no intention or necessity of liquidate or curtail significantly the scale of operation.
- (b) The auditor should plan and perform procedures designed to identify material matters which might enable the auditor to form an opinion on the going-concern status of a company. These procedures should include the following:
- (i) A review of forecast and budget information produced by a company, and the quality of the systems in place for producing this information. This would include a review of the key assumptions underlying the forecasts and budgets, and a review of the cash flow budget.
  - (ii) A review of the evidence relating to the adequacy and period of borrowing facilities. The auditor may need to obtain written information from banks or other third parties in order to be able to assess the degree of their commitment.
  - (iii) A review of the inherent risk assigned to the audit client. The sensitivity of forecasts and budgets to variable factors both within the directors' control and outside their control will be scrutinised, including relevant economic factors.
  - (iv) A review of the directors' plans for overcoming any problems their company is having or resolving any matters giving rise to doubts about the appropriateness of the going-concern basis. The auditor should consider the basis on which they have been prepared, whether they are realistic and whether the plans are likely to resolve the company's problems.
  - (v) A consideration of any professional advice obtained by the directors as to the extent of the company's difficulties and the practicalities of overcoming them. It may be necessary for the directors to obtain legal advice on the consequences of the company continuing to trade while it is known by the directors not to be a going concern.
  - (vi) A review of the financial records including the order book, directors' minutes and an analytical review of the financial statements.
- The nature and scope of the auditor's procedures will depend upon the circumstances of the client. The extent of the procedures will be determined by the extent of the resources it requires to continue as a going concern.
- (c) The following are examples of factors which might cast doubt on the going-concern status of a company:
- (i) internal matters such as loss of key management, labour difficulties or excessive dependence upon a few product lines where the market is depressed

- (ii) external matters such as loss of key suppliers or customers or technical developments which render a key product obsolete
- (iii) an excess of liabilities over assets
- (iv) default on terms of loan agreements
- (v) significant liquidity or cash flow problems
- (vi) major litigation in which an adverse judgement would imperil the company's continued existence
- (vii) denial of normal terms of credit by suppliers
- (viii) major debt repayment falling due where refinancing is necessary to the company's continued existence.

2. Responsibility of the Auditor: The Auditor's education and experience enables him to be knowledgeable about business matters in general but he is not expected to have the expertise of a person trained for or qualified to engage in the practice of another profession or occupation such as an actuary or engineer.

When the auditor uses work performed by experts he continues to be responsible for forming and expressing his opinion on the financial information.

Evaluating the work of an expert: The auditor should obtain reasonable assurance that work performed by experts is adequate. He should satisfy himself as to the expert's skill and competence.

The auditor should seek reasonable assurance that the expert's work constitutes appropriate audit evidence in support of the financial information, by considering:

- (i) the source data used;
- (ii) the assumptions and methods used and if appropriate, their consistency with the prior period; and
- (iii) the results of the expert's work in the light of the auditor's overall knowledge of the business and of the results of his audit procedures.

The auditor should consider whether the expert has used source data which are appropriate in the circumstances. The procedures to be applied by the auditor should include:

- (i) making inquiries of the expert to determine how he has satisfied himself that the source data are sufficient, relevant and reliable; and
- (ii) conducting audit procedures on the data provided by the client to the expert to obtain reasonable assurance that the data are appropriate.

The appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the expert. The auditor does not have the same expertise and therefore, cannot always challenge the expert's assumptions and methods. However, the auditor should obtain an understanding of those assumptions and methods to determine that they are reasonable based on the auditor's knowledge of the client's business and on the result of his audit procedures.

Normally, completion of the above procedures will provide the auditor with reasonable assurance that he has obtained appropriate audit evidence in support of the financial information. If the work of an expert does not support the related representations in the financial information, the auditor should attempt to resolve the inconsistency by discussions with the client and expert. Applying additional procedures, including possibly engaging another expert, may also assist the auditor in resolving the inconsistency.

If, after performing these procedures, the auditor concludes that the work of the expert is inconsistent with the information in the financial statements, or that the work of the expert does not constitute sufficient appropriate audit evidence, he should express a qualified opinion, a disclaimer of opinion or an adverse opinion, as appropriate.

3. (i) The detection of a fraud committed by the Managing Director involving a loss to the company is a serious matter irrespective of the fact that the Managing Director has fully compensated the company before the close of the year. In this context, AAS 4 on "The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements" enumerates responsibilities of the auditor in case fraud or error is found to exist while conducting the audit. It requires, first of all that auditor should consider the implications of the circumstances on the true and fair view which the financial statements ought to convey and secondly, where the significant fraud has occurred, that auditor should consider the necessity for a disclosure of fraud in the financial statements and if adequate disclosure is not made, the necessity for a suitable disclosure in his report.
- (ii) The auditor should satisfy himself regarding the necessity for such large balances having regard to the normal working requirements of the company". Further, the auditor should conduct a surprise verification after the year end to ascertain whether the actual cash on hand agrees with the balance as shown by the books. If the cash on hand is not in agreement with the balances as shown in the books, it should be his duty to call for an explanation. In the absence of any satisfactory explanation for material difference, the auditor's duty is to draw the attention of the members in his report to this fact.
4. The auditor would be unlikely to use audit sampling techniques in the following situations.
  - (i) Where the population size is so small that statistical sampling will create unacceptable margins of error. If the population is not sufficiently large then statistical methods are invalid. Also where transactions or balances are small in number and material in relation to the financial statements. For example all large unusual items should be verified.
  - (ii) Where the population is not homogeneous and requires stratification. For example stock and work in progress may need stratifying because of the diverse nature of the population and the need to increase the precision of the sampling unit. Raw material stocks, work in progress and finished good stocks are unlikely to represent a homogeneous population.
  - (iii) Where the population has not been maintained in a manner suitable for audit sampling. For example sales invoices may have been filed in customer order and not numerically. Audit sampling techniques would not be cost effective in these circumstances.
5. (a) (i) For tangible fixed assets, the audit risk will be higher when they have a large value, or when the fixed assets may be worth materially less than the value shown in the balance sheet. Although the value of land and buildings is likely to be quite large, their market value should be higher than the value in the accounts, particularly if they have been acquired many years ago and have not been revalued recently. Fixed assets may be worth substantially less than the balance sheet value when they are obsolete or have to be sold at a loss. This will include companies which are making losses, those which are having going concern problems and those where a certain activity, which uses the fixed asset, is being discontinued or is likely to be discontinued.

Machinery has a higher risk of obsolescence where:

- Ø it is used to produce a specialised product which may go out of fashion, or be replaced by another product which requires different equipment.
- Ø it is high technology equipment which is more likely to become obsolete. Also, the company may fail to get it operating satisfactorily, the supplier may go out of business, or it may be impossible to repair because either the replacement parts are no longer available or no further service support is provided (this sometimes happens with computers).

There may be a high risk where finance leased equipment is included in the balance sheet and the company is having going concern problems. On liquidation the equipment will not belong to the company.

- (ii) Stock has a high level of audit risk in most companies as it usually has a material value in the balance sheet. Stock is a high risk area as its value is entered in the accounts at

the year end, and it is not maintained as an accounting record like trade debtors. Frequently stock quantities are found only at the physical stocktake, and the value per unit may be worth less than cost, yet it may have been valued at cost. In manufacturing companies stock value will be more difficult to determine than in other companies, as it includes direct labour cost and production overheads. Old stock will probably have to be valued at net realisable value, and some of this stock may be worth only scrap value. This stock will include raw materials, work in progress and finished goods for products the company no longer sells. Some of this stock may arise because more stock was purchased than was used in production. The valuation of specialised stocks, and spare parts (eg, for cars) may be difficult, particularly if they have been in stock a long time.

- (iii) In most manufacturing companies, debtors have a lower risk than stock and creditors. The audit risk is mainly related to the level of bad debts the company incurs. There will be a lower risk where a company sells to large companies, rather than to a large number of small businesses. There is a greater risk when debts are old, when the company has many new customers or when the general age of the company's debtors is increasing. If the company sells goods subject to reservation of title, this will reduce the risk of bad debts, provided the retention of title clause is legally enforceable.

Creditors are likely to be a higher risk than debtors. The main risk is that certain creditors may have been omitted. Usually, this arises from poor records of receipt of goods, inadequate matching of invoices to goods received, or poor systems for following up differences between suppliers' statements and the purchase ledger balances. The risk will be relatively high where the company has a large number of outstanding disputes with suppliers (e.g., for short delivery of goods, quality problems and pricing disputes). Trade creditors are frequently a problem where a company is having going concern problems, as there may be inadequate recording of transactions and round-sum payments to creditors make reconciling suppliers' statements more difficult.

- (iv) Contingencies will have high risk where large claims for damages are being made against the client. Also, contingencies can be important where an activity of the business is being terminated. In this situation there may be claims by employees, customers, suppliers and amounts due on termination of leases. Claims for damages can arise for many reasons. These include damage to another person's property (eg, in extracting minerals), claims by employees due to damaging their health, claims by competitors for alleged infringement of their copyrights, and fines due to contravention of the law. Also, in some types of business, such as civil engineering construction, there is a potential liability for claims arising from using faulty materials (eg, the use of high alumina cement in the construction of buildings). Claims arising from faulty products can be very substantial, particularly if the fault has resulted in loss of life, such as claims arising from aircraft accidents. Contingencies can be a high risk area, as it is easy to fail to detect the risk of a potential liability, and even if the potential claim is highlighted, it can be very difficult to quantify the sum it will cost the company.

- (b) Consideration of audit risk by auditors has become important for the following reasons:

- (i) Audit risk is concerned with highlighting areas where there is a high risk of the accounts being incorrect.
- (ii) However, if the time spent on an audit is reduced the risk of a material error not being detected is increased, so there is an increased risk that the auditor may be sued for negligence. The only way to reduce the auditor's risk is to increase the efficiency in carrying out an audit.
- (iii) So, the concept of audit risk and materiality has been used to improve audit efficiency. If an item in the accounts is small (eg, petty cash of Rs.1,000) even a 100% error in its value will have an insignificant effect on the profit before tax, so the error will be



immaterial. The larger the value of the item in the balance sheet, the greater is the risk that an error in its value will be material. However, one has to consider the risk that the item may be incorrect and the size of the potential error. As described in part (a) of the question, the value of the bad debt provision in most companies accounts is relatively small, so the risk of debtors being materially misstated is small. However, there is a much greater risk that the value of stock may be misstated, as not only does stock have a high value, but there is a high risk that it may be materially misstated.

- (iv) The result of consideration of audit risk and materiality is that auditors should concentrate their work in areas where there is the highest risk that there may be errors in the accounts. In this way they increase the efficiency of their audit work and reduce the risk that they may fail to detect material errors.
  - (v) From this discussion, one of the results of consideration of audit risk on the audit of the accounts of large companies is that some auditors perform fewer checks on the processing of transactions through the accounting systems (where the risk of errors is small, because they should be detected and corrected by the system of internal control) and more time is spent in reviewing financial statements and in the audit of certain balance sheet items.
  - (vi) With the increase in litigation against auditors, the risk of an auditor being sued by the company or a third part (eg, the company's creditors) is increasing, and the sums auditors have to pay in damages are increasing. Although many of the claims are covered by indemnity insurance cover, the cost of this insurance is increasing, particularly for firms with a poor claims record. However, by considering audit risk the probability of errors in the accounts being undetected is reduced, which enables the audit to be carried out more efficiently, thus saving the time spent on the audit whilst keeping the risk of litigation to a minimum.
6. (a) (i) Provided the valuation comes from an independent, qualified and experienced valuer, this evidence is obtained from a well qualified and competent individual. However, valuation of land and buildings is very difficult and can be subject to considerable error. It is easier to value properties if there are a large number of similar properties available (eg, small industrial units and small shops), as the valuer should be aware of how much similar properties are selling for and he can use these values to estimate the value of the client's property. If the property is large or of a specialised nature the valuation may be unreliable. With a specialised property (eg, a car manufacturing plant) there is the question of whether the purchaser wants to use the property for the same use, or he may decide to demolish it to construct a building for a different purpose. If the buyer wants to demolish the property, the value of the land and buildings will be no more than the value of the land (ie, it could be worth the value of the land less the cost of demolishing the buildings).

Thus, a 'normal sale' will achieve a much higher price than a forced sale (eg, arising from a liquidation). An example of this is that repossessed houses sold for much lower prices than other houses where the seller was in no hurry to sell the property.

- (ii) The replies to a debtors' circularisation are moderately reliable. The limitations are that some debtors agree every reply to a debtors' circularisation, when it is apparent that there are disputed invoices. Also, some debtors may disagree the client's balance, and I, as auditor, will have to check whether the differences are validly goods and cash in transit, or whether they are disputes. Goods in transit are goods sent to the customer shortly before the year end, the invoice of which has not been posted to the client until shortly after the year end. A practical problem is that many debtors do not reply to the circularisation (many debtors never reply to any circularisation) and some debtors say they cannot confirm the balance. As the replies to debtors' circularisations are sent direct to the auditor's office by the debtor, it is impossible for the company to amend the debtor's reply.

A significant weakness of a debtors' circularisation is that it does not confirm whether the debt is good (ie, the debtor can reply agreeing the balance but he may be unable to pay the sum due). So, alternative audit procedures have to be carried out to check whether the debt is good.

As far as the quality of audit evidence is concerned, in carrying out a debtors' circularisation one is checking the customer's purchase ledger. In practice, purchase ledgers tend to be less reliable than sales ledgers, as there are often delays between receiving the goods and the purchase invoice and in checking the purchase invoice. These delays mean that most purchase ledgers have some cut-off errors (ie, goods have been received before the year end but the purchase invoice has not been posted to the purchase ledger before the year end). Sales ledgers tend to be more accurate as the dispatch of goods, preparation of the sales invoice and posting it to the sales ledger are under the client's control and they are usually carried out within a day. Also, sales ledgers have to be accurate to ensure the company receives cash from sales promptly, and thus minimise cash flow problems.

- (iii) The letter from the bank is excellent audit evidence, as banks are a very reliable source of evidence, and the letter is sent direct to the auditor, thus preventing the client from manipulating figures. These comments apply to bank letters received from clearing banks. With any bank, the reported overdraft should be correct, but, if the bank is in financial difficulties, the balance of cash at the bank may not be recoverable. Although it is unusual for balances of cash at the bank to be doubtful, this did arise for depositors in BCCI (ie, an example of a bank which failed).

In conclusion, the valuation from a valuer is probably the least reliable form of audit evidence because of the difficulty in valuing properties (as described in the answer). The replies to a debtors' circularisation are less reliable than the letter from the bank which is the most reliable form of third party audit evidence.

- (b) In order to check the accuracy of the valuation, would first check the independence, qualifications and experience of the valuer. On independence, the valuer should work for (or be a partner of) a firm of valuer and he should not be an employee of the audit client or related to the directors of the audit client. On qualifications, he should be a member of a professional body. The valuer should be experienced in valuing similar properties to the client's and in the same geographical area. For instance, the valuation would be unreliable if the valuer was only experienced in valuing domestic properties and the client owned industrial properties. Also, the valuer should have experience in valuing properties in the same geographical area as the client. The basis of the valuation should normally be an existing use valuation. It would not normally be appropriate to use the rebuilding cost of the property as a valuation base (except for insurance purposes).

In order to check that the value of the property is reasonable, inspect the property and check that its value is consistent with the value of similar properties. Also, the price properties are advertised by estate agents is a guide, although the estate agent's asking price is likely to be higher than the finally agreed sale price.

- (c) In order to check the accuracy of the cash book balance in the company's accounts, obtain a copy of the bank reconciliation from the client and:
  - (i) check the additions on the bank reconciliation
  - (ii) check receipts and payments from the bank statement to the cash book for the month before the year end.
  - (iii) note uncleared items at the year end from the cash book (and the previous month's bank reconciliation) and agree them to the bank reconciliation
  - (iv) check the clearance of the items after the year end
  - (v) most cheque payments should have cleared within a week of the year end. If there are a significant number of cheques uncleared two weeks after the year end, it is an



indication that the cheques were not posted to creditors until after the year end. So, these payments should be reversed in the cash book and added to creditors at the year end (ie, a payment is normally treated as a payment when the cheque is sent to the creditor)

- (vi) lodgements should be cleared within two banking days of the year end. If there is a longer delay, it indicates there may be a teeming and lading fraud. To check if there is a teeming and lading fraud, check that yesterday's cash receipts were banked either yesterday evening or today (by checking the entry in the cash book and the date stamped by the bank on the copy of the paying-in-slip). If there is a delay, unbanked cheques and cash – if they are 'missing', a teeming and lading fraud is taking place.
- (vii) agree the balance per the bank on the bank reconciliation to the bank letter and the bank statement
- (viii) agree the cash book balance on the bank reconciliation to the cash book and draft accounts.

If there is more than one bank account, the reconciliation of all the bank accounts should be checked. The number of bank accounts should agree to the number in the bank letter (or if the accounts are held at more than one bank or branch, check them with letters received from all the banks where accounts are held). check the validity of all accounts opened and closed in the year, by checking the last statement for accounts closed and the first for accounts opened.

7. (a) It is essential that the accountant clearly brings out the nature of association with the financial statements and the nature of the work performed by him. The report on compilation engagements should, ordinarily, be in the following lay out:
  - (i) *Title*: The title of the report should be "Accountant's Report on Compilation of Unaudited Financial Statements" (and not "Auditor's Report");
  - (ii) *Addressee*: The report should ordinarily be addressed to the appointing authority;
  - (iii) Identification of the financial information also noting that it is based on the information provided by the management;
  - (iv) When relevant, a statement that the accountant is not independent of the entity;
  - (v) A statement that the management is responsible for:
    - (a) completeness and accuracy of the underlying data and complete disclosure of all material and relevant information to the accountant;
    - (b) maintaining adequate accounting and other records and internal controls and selecting and applying appropriate accounting policies;
    - (c) preparation and presentation of financial statements or other financial information in accordance with the applicable laws and regulations, if any;
    - (d) establishing controls to safeguard the assets of the entity and preventing and detecting frauds or other irregularities;
    - (e) establishing controls for ensuring that the activities of the entity are carried out in accordance with the applicable laws and regulations and preventing and detecting any non-compliance;
    - (f) A statement that the engagement was performed in accordance with this Auditing and Assurance Standard;
    - (g) A statement that neither an audit nor a review has been carried out and that accordingly no assurance is expressed on the financial information;
    - (h) A paragraph, when considered necessary, drawing attention to the disclosure of material departures from the identified financial reporting framework;
    - (i) Date of the report;

- (j) Place of signature; and
  - (k) Accountant's signature: The report on compilation of financial information should be signed by the auditor in his personal name. Where a firm is appointed for the engagement, the report should be signed in the personal name of the accountant and in the name of the firm. The partner/proprietor signing the report on compilation of financial information should also mention the membership number assigned by the Institute of Chartered Accountants of India
- (b) The report on an agreed-upon procedures engagement needs to describe the purpose and the agreed-upon procedures of the engagement in sufficient detail to enable the reader to understand the nature and the extent of the work performed. The report should also clearly mention that no audit or review has been performed. The report of factual findings should contain:
- (a) Title;
  - (b) Addressee (ordinarily, the appointing authority );
  - (c) Identification of specific financial or non-financial information to which the agreed-upon procedures have been applied;
  - (d) A statement that the procedures performed were those agreed-upon with the recipient;
  - (e) A statement that the engagement was performed in accordance with the Auditing and Assurance Standard applicable to agreed-upon procedures engagements;
  - (g) Identification of the purpose for which the agreed-upon procedures were performed;
  - (h) A listing of the specific procedures performed;
  - (i) A description of the auditor's factual findings including sufficient details of errors and exceptions found;
  - (j) A statement that the procedures performed do not constitute either an audit or a review and, as such, no assurance is expressed;
  - (k) A statement that had the auditor performed additional procedures, an audit or a review, other matters might have come to light that would have been reported;
  - (l) A statement that the report is restricted to those parties that have agreed to the procedures to be performed;
  - (m) A statement (when applicable) that the report relates only to the elements, accounts, items or financial and non-financial information specified and that it does not extend to the entity's financial statements taken as a whole;
  - (n) Date of the report;
  - (o) Place of signature ; and
  - (p) Auditor's signature

The report should be signed by the accountant in his personal name. Where the firm is appointed, the report should be signed in the personal name of the accountant and in the name of the firm. The partner/proprietor signing the report on agreed-upon procedures should also mention the membership number assigned by the Institute of Chartered Accountants of India

8. **Audit of Indirect Taxes:** The components of central indirect tax which form a part of the materials cost could be basic customs duty, additional duty of customs, special additional duty, excise duty (Cenvat), special excise duty, additional duties of excise, etc. The various components have a relationship with each other and also with central and local sales tax. The audits of in this area are redirected to the audit under sections 14A and 14AA of the Central Excise act, 1944. All these audits are conducted by or on behalf of the Government. The steps involved in conducting indirect tax audit are as under:

1. Evaluate the internal control systems in general with specific weight given to the strength of the systems in aiming at the quantification and discharge of the indirect taxes. The auditor should ensure that the accounting system and related internal control in this area are covered in terms of AAS-6. Internal control questionnaire may be designed specifically for the area of indirect taxation.
2. Obtains information about the company and the industry. Specific information on amount of imports, percentage of customs, amount of removals, quantum of cenvat-proportion of credit could also be calculated. The walk through of the process from the point of ordering of materials till the receipt of the payment from the customer is advisable.
3. Formulating an audit programme to assist in the actual conduct of the audit. The actual extent of verification would be dependent on the results of the evaluation of the internal controls.
4. Ensure that the audit staff is knowledgeable in the law and the procedures governing the indirect taxes. The examination of the documents, physical verification, reconciliation tracing techniques, comparison of ratios, observation of the activities and discussions of the weaknesses observed should be part of an effective audit.
5. Prepare a report on the indirect tax audit providing specific comments on the statutory information, material matters reported by way of an executive summary and the assertion/qualification that the acceptable accounting policies are in vogue.
9. **Key functions of Energy Auditor:** Energy auditing is defined as an activity that serves the purposes of assessing energy use pattern of a factory or energy consuming equipment and identifying energy saving opportunities. In that context, energy management involves the basis approaches reducing avoidable losses, improving the effectiveness of energy use, and increasing energy use efficiency. The function of an energy auditor could be compared with that of a financial auditor. The energy auditor is normally expected to give recommendations on efficiency improvements leading to monetary benefits and also advise on energy management issues. Generally, energy auditor for the industry is an external party. The following are some of the key functions of the energy auditor:
  - (i) Quantification of energy costs and quantities
  - (ii) To correlate trends of production or activity to energy cost.
  - (iii) To devise energy database formats to depict to correct picture – By product, department or consumer.
  - (iv) To advise and check the compliance of the organisation for policy and regulation aspects.

While performing the aforesaid key functions, the energy auditor is required to carry out the following activities:

- (i) To analyse the historical energy consumption and cost data.
- (ii) To conduct preliminary energy audit with the objectives to identify:
  - (a) major energy consuming equipment and process;
  - (b) obvious inefficiencies and energy wastes; and
  - (c) priority areas for further detailed investigation.
- (iii) To conduct detailed technical and economic analysis of energy efficiency measures involving large efficiency measures involving large capital investment or long payback periods.
10. **Companies Covered by the Order:** The Order applies to all companies except certain categories of companies specifically exempted from the application of the Order.

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

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

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

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

*Companies not Covered by the Order:* Paragraph 2 of the Order provides that it shall not apply to:

- (i) a banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
  - (ii) an insurance company as defined in clause (21) of section 2 of the Companies Act, 1956 (1 of 1956);
  - (iii) a company licensed to operate under section 25 of the Companies Act, 1956 (1 of 1956); and
  - (iv) a private limited company with a paid-up capital and reserves not more than rupees fifty lakh and which does not have outstanding loan exceeding rupees twenty five lakhs from any bank or financial institution and does not have a turnover exceeding rupees five crores at any point of time during the financial year.
11. **Paid-up Capital and Reserves:** Sub-section (32) of section 2 of the Act defines the term "paid-up capital" as capital credited as paid-up. The Guidance Note on Terms Used in Financial Statements, issued by the Institute of Chartered Accountants of India, defines the term "paid-up share capital" as, "that part of the subscribed share capital for which consideration in cash or otherwise has been received. This includes bonus shares allotted by the corporate enterprise". Paid-up share capital would include both equity share capital as well as the preference share capital. While calculating the paid-up capital, amount of calls unpaid should be deducted from and the amount originally paid-up on forfeited shares should be added to the figure of paid-up capital. Share application money received should not be considered as part of the paid-up capital.

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

As mentioned in the preceding paragraph, reserves are primarily of two types—capital reserves and revenue reserves. According to the Guidance Note on Terms Used in Financial Statements, the term "capital reserve" means "a reserve of a corporate enterprise which is not available for distribution as dividend". The said Guidance Note defines the term "revenue reserve" as "any reserve other than capital reserve". For determining the applicability of the Order to a private limited company, both capital as well as revenue reserves should be taken into consideration while computing the limit of rupees fifty lakhs prescribed for paid-up capital and reserves.

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

*Loan Outstanding:* Loans from banks or financial institutions are normally in the form of term loans, demand loans, export credits, working capital limits, cash credits, overdraft facilities, bills purchased or discounted. Outstanding balances of such loans should be considered as loan outstanding for the purpose of computing the limit of rupees twenty five lakhs. Non-fund based credit facilities, to the extent such facilities have devolved and have been converted into fund-based credit facilities, should also be considered as outstanding loan. The figures of outstanding loan would also include the amount of bank guarantees issued by the company where such guarantee(s) has (have) been invoked and encashed or where, say, a Letter of Credit has devolved on the company. In case of term loans, interest accrued and due is considered as a loan whereas interest accrued but not due is not considered as a loan. Further, in case the company enjoys a facility, say, a cash credit facility, whose balance is fluctuating in nature, the Order would apply to the company in case on any day during the financial year concerned, the amount outstanding in the cash credit facility exceeds Rs. 25 lakhs. The condition laid down in the Order is that the outstanding loan from a bank or financial institution is exceeding Rs. 25 lakh. There is no stipulation in the Order that the loan should be a long-term loan or a short-term loan or that it should be a secured loan or an unsecured loan. Therefore, the Order would be applicable to a private limited company even if the loan outstanding is a short-term loan. Further, the condition would also apply notwithstanding the fact that the company has been granted an overdraft facility against, say, fixed deposits, of the company with the concerned bank. Moreover, outstanding dues in respect of credit cards would also be considered while calculating the limit of Rs. 25 lakh in respect of loan outstanding from a bank or financial institution. It is clarified that since the words used by the Order are 'any bank or financial institution', the limit of "exceeding twenty five lakh rupees" would apply in aggregate to all loans and not with reference to each bank or financial institution. For example, if a private limited company has three outstanding loans of rupees nine lakhs each from two banks and a financial institution, the Order would be applicable to such a private limited company.

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

*Turnover:* The term, "turnover", has not been defined by the Order. Part II of Schedule VI to the Act, however, defines the term "turnover" as the aggregate amount for which sales are effected by the company. It may be noted that the "sales effected" would include sale of goods as well as services rendered by the company. In an agency relationship, turnover is the amount of commission earned by the agent and not the aggregate amount for which sales are effected or services are rendered. The term "turnover" is a commercial term and it should be construed in accordance with the method of accounting regularly employed by the company. For ascertaining the limit of rupees five crores:

- (a) sales tax collected or excise duty collected should not be taken into account if they are credited separately to sales tax account or excise duty account;
  - (b) trade discounts should be deducted from the figure of turnover;
  - (c) commission allowed to third parties should not be deducted from the figure of turnover;
  - (d) sales returns should be deducted from the figure of turnover even if the returns are from the sales made in the earlier years. As a corollary, any sales returns etc., in respect of the sales made during the year under report, if received after the end of that year, would not be deductible from the figure of turnover of such year; and
  - (e) The income received by way of rent or dividend/interest would not form part of "turnover". However, Part II of Schedule VI to the Companies Act, 1956 clarifies that in case of companies rendering or supplying services, gross income derived from services rendered or supplied, would be shown as turnover. Therefore, in cases where the principal business of the company is letting out of property of the company or it is an investment company, the rent or dividend/interest, respectively, would constitute "turnover".
12. (a) Clause 13 of Part I of the First Schedule to the Chartered Accountants Act, 1949 states that "a Chartered Accountant in practice is deemed to be guilty of professional misconduct if he allows a person not being a member of the Institute or a member not being his partner, to sign on behalf or on behalf of his firm any balance sheet, profit and loss account, report or financial statement". This clause is to be read in conjunction with Section 26 of the Chartered Accountants Act, 1949 which stipulates that 'no person other than a member of the Institute shall sign any document on behalf of a chartered accountant in practice or a firm of chartered accountants in his or its professional capacity. A report, however, may cover a wider range of documents but in the context in which it used in this Clause, it would mean only a report arising out of a professional assignment undertaken by him or his firm and submitted by him or his firm to the client(s) or where so required to an outsider on behalf of himself or on behalf of a firm. The subject matter of report should be the expression of professional opinion whether financial or non financial. The financial statements and the reports referred to in this Clause obviously mean the financial statements and reports as ultimately finalised and submitted to outside authorities. As it is obvious that reports and financial statement pertains to the company, professional misconduct has been committed by the firm in terms of Clause 13 referred to above.
- (b) Clause 7 of Part I of the Second Schedule to the Chartered Accountants Act, 1949, states that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct, "if he is grossly negligent in the conduct of his professional duties". This implies, whether or not the accountant has honestly and reasonably discharged his duties. Professional misconduct on the part of a person practising one of the technical professions, cannot fairly or reasonably be found merely on a finding of a bare non-performance of a duty or some default in performing it. The charge is not one of inefficiency but of misconduct and in an allegation of misconduct, imputation of a certain mental condition is always involved. The test must always be whether in addition to a failure to do the duty there has been a failure to act honestly and reasonably". (S. Ganesan vs. A.K. Joscelyne) keeping this in view it can be said in the instant case that the chartered accountant while sending the report by V.P.P. had only failed to perform his duty of signing the report. Mere non-signing cannot be imputed for non-performance of a duty or some default in performing it. However, as the



auditor has sent the report by V.P.P. so as to cover his audit fees payable the intention of the auditor as imputed from his action and mental audit fees payable the intention of the auditor as imputed from his action and mental condition is to recover the fees. Under the circumstances, it seems that the auditor has failed to act honestly and reasonably and therefore, he has committed professional misconduct.

- (c) Clause 6 of Part I of the First Schedule to the Chartered Accountants Act, 1949 states that a chartered accountant in practice shall be deemed to be guilty of misconduct, "if he solicits clients or professional work either directly or indirectly by a circular, advertisement, personal communication or interview or by any other means". Such a restraint has been put so that members maintain their independence of judgement and may be able to command respect from their prospective clients. In case of making an application for empanelment for allotment of audit and other professional work, the Council has opined that "where the existence of such a panel is within the knowledge of a member, he is free to write to the concerned organisation with a request to place his name on the panel". However, it would not be proper for the chartered accountant to make roving inquiries by applying to any such organisation for having his name included in any such panel. Accordingly the chartered accountant is guilty of misconduct in terms of the above provision as he has solicited professional work from the Finance Ministry as the chartered accountant is inquiring about the maintenance of panel.
13. (i) Statutory Dues not Deposited: In case dues of Income Tax/ Sales Tax/ Service Tax/ Customs Duty/ Wealth Tax/ Excise Duty/ Cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned.
- (a) This clause requires that in case of disputed statutory dues, the amounts involved should be stated along with the forum where the dispute is pending.
  - (b) The audit procedures applied by the auditor for commenting on the previous clause, including obtaining a statement from the management in regard to the matters specified in the clause, would help the auditor in determining the dues of sales tax/income tax/custom duty/wealth tax/service tax/excise duty/cess that have not been deposited on account of any dispute, the amounts involved and the forum where dispute is pending. The auditor should also obtain a management representation about the disputed dues, the amounts involved and the forum where the dispute is pending. The auditor should carry out necessary audit procedures to verify the information provided by the management.
  - (c) It is clarified here that mere representation to the concerned Department does not constitute dispute. According to the Order, it is necessary that there should be an appeal before the relevant appellate authority. It is, however, reiterated that where an application for rectification of mistake (e.g., under Section 154 of the Income tax Act, 1961) has been made by the company, the amount should be regarded as disputed.
  - (d) A show-cause or similar notice generally contains the requirements/queries of the assessing officer. Normally, issuance of a show cause notice by the concerned department should not be construed to be a demand payable by the company. However, in some cases, a show cause notice and demand may be combined in one document. Normally, in such cases, the demand would not be construed to have arisen till the time the assessee has disposed off the requirements of the show cause order. Hence, it would be necessary to evaluate each situation individually.
  - (e) Tax demands that have been set aside are clearly not 'dues'. Similarly, if a demand has been referred for reassessment and the effect of such referral is the cancellation of the earlier demand, this too would not constitute an amount due. The wording of the order would be of significance; if the demand is not cancelled, it will remain disputed dues. As far as demands that have been stayed are concerned, these should be regarded as disputed dues. These should be disclosed along with a disclosure of the

fact of stay. The fact that a stay has been granted does not mean that the authority granting the stay has held that the amount in question is not a valid demand against the company. The stay normally is a concession that the amount may not be deposited immediately or that it may be deposited in installments. Sometimes a stay is granted if the assessee provides a bank guarantee. It may also be noted that there may be a situation that the appellate authority has decided a case in favour of the company but the Department may prefer to make an appeal to a higher authority. In such a case, there is considered to be no dispute until the time the Department makes an appeal to the relevant appellate authority. Further, in case where the amount under the dispute is pending for an appeal to be filed and the time limit for filing the appeal has lapsed, the disputed amount would become a statutory due and the reporting responsibilities of the auditor as are applicable to any other undisputed statutory due under clause 4(ix)(a) of the Order would become applicable. Further, in case where the amount under dispute has not been paid before filing the appeal and no appeal is filed within the time allowed and the time limit for filing the appeal has expired, the disputed amount would become a statutory due.

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

*Statement of Disputed Dues*

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

- (h) Further, a plain reading of the clause suggests that the amounts to be reported under clause 4(ix)(b) of the Order are those which have not been deposited on account of any dispute, irrespective of the treatment of such disputed amounts in accounts. It is quite possible that an amount is disputed and has not been deposited but on consideration of the likely outcome of the dispute, a provision has been made in the accounts. Such an amount will need to be reported, notwithstanding that it has been provided for. Similarly, even if it had not been provided for, it would have to be reported as long as it is not deposited. It is also possible that an amount is disputed, has been deposited and on consideration of the likely outcome of the dispute, has been shown as a recoverable. Though such an amount is not contemplated for reporting under the clause, since it has been deposited, the fact of such deposit having been made under protest should be brought out by the auditor in his report under the clause.

Whether a disputed amount should be provided for in the accounts or not will need to be judged in the context of Accounting Standard (AS) 4, "Contingencies and Events Occurring After the Balance Sheet Date and/or Accounting Standard (AS) 29, "Provisions, Contingent Liabilities and Contingent Assets".

- (ii) Repayment of Dues: Whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported.
- (a) Under this clause, the auditor is required to report whether the company has defaulted in repayment of dues to a financial institution or bank or to debenture holders. If the answer is in the affirmative, the auditor is also required to mention the period of default and the amount of default. A question that arises is whether the scope of the auditor's inquiry would cover defaults made by the company during the year only or whether the defaults committed in previous years and continuing upto the year end would also be covered. It is clarified that the auditor should report the period and amount of all defaults existing at the balance sheet date irrespective of when those defaults have occurred.
  - (b) Dues to financial institutions, banks or debenture holders would include the principal as well as any interest on any kind of dues payable to the financial institutions, banks or debenture holders.
  - (c) The auditor should obtain a schedule of repayments to banks, financial institutions and debenture holders from the management of the company. The schedule should indicate the amount and the due dates of the payments that the company is required to make to banks, financial institutions and debenture holders.
  - (d) The auditor should examine the agreement or other documents containing the terms and conditions of the loans and borrowings of the company from banks and financial institutions. The auditor should also examine the debenture trust deed. This examination would enable the auditor in verifying the amount and due dates of the payments mentioned in schedule of repayments provided by the management of the company. The auditor should then verify whether the repayments as per the books of account are in accordance with the terms and conditions of the relevant agreement. The auditor should also satisfy himself that the repayment have actually been made to the party concerned.
  - (e) Though the word "default" has not been defined, in this regard, the word "default" would mean non-payment of dues to banks, financial institutions or debenture holders on the last dates specified in loan documents or debentures trust deed, as the case may be. For example, in the case of term loans, fixed dates are prescribed for repayment in the agreement or terms and conditions of the loans. The dates prescribed for repayments would operate as the last date of payments and any delay after this fixed date would amount to default.
  - (f) It may happen that the company might have submitted application for reschedulement/restructuring proposals to the lenders, which may be in different stages of processing. Submission of application for reschedulement/restructuring does not mean that no default has occurred. Accordingly, in such situations also the auditor should report the period of default and the amount of default. However, if the application for reschedulement of loan has been approved by the concerned bank or financial institution or if the default has been made good by the company during the accounting period covered by the auditor's report, the auditor should state in his audit report the fact of reschedulement of loan or the fact of default having been made good.
  - (g) The auditor may come across a situation where there may be disputes between the company and the lender on certain issues relating to repayments. In all such situations, the auditor should give a disclaimer that since there is a dispute between the company and the lender; he is unable to determine whether there is a default in repayment of dues to the lender concerned.

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

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

14. (a) In case of a guarantee furnished as a security or cover for an existing liability which is already recorded in the books, as far as disclosure is concerned, it is not necessary to refer to the guarantee by way of note, since the principal liability is already recorded and the guarantee does not create any further liability either actual or contingent. Where the guarantee is given by a party other than the company, to secure the liability of the company, a note may, if so desired, be made merely by way of information.
- (b) In respect of disclosure of a guarantee furnished as security or cover for a contingent liability, it would be more appropriate to disclose the contingent liability itself rather than the guarantee, not only because it is the former which requires disclosure under the Companies Act but also because the guarantee may have been furnished for a possible aggregate sum not equal to or related to the estimated amount at the balance sheet date of the contingent liability required to be disclosed.
- (c) The question of disclosure of guarantee(s) would also arise in the case of a company which receives a guarantee from a debtor or from person to whom a loan has been advanced or from whom money or other obligation is owing to the company, or who is obligated to the company for the performance of services or otherwise. In all such cases, no disclosure of the guarantee is required unless the guarantee is supported by tangible security in which case the classification of the debt, loan, or advance, as the case may be would be "secured" to the extent of the value of the security.
15. (a) Section 292A of the Companies Act, 1956 relating to Audit Committee contain following provisions:
- (1) Every public company having paid-up capital of not less than five crores of rupees shall constitute a committee of the Board known as "Audit Committee" which shall consist of not less than three directors and such number of other directors as the Board may determine of which two-thirds of the total number of members shall be directors, other than managing or whole-time directors.
  - (2) Every Audit Committee constituted under sub-section (1) shall act in accordance with terms of reference to be specified in writing by the Board.
  - (3) The members of the Audit Committee shall elect a chairman from amongst themselves.
  - (4) The members of the company shall disclose the composition of the Audit Committee.
  - (5) The auditors, the internal auditor, if any, and the director-in-charge of finance shall attend and participate at meetings of the Audit Committee but shall not have the right to vote.
  - (6) The Audit Committee should have discussions with the auditors periodically about internal control systems, the scope of audit including the observations of the auditors and review the half-yearly and annual financial statements before submission to the Board and also ensure compliance of internal control systems.
  - (7) The Audit Committee shall have authority to investigate into any matter in relation to the items specified in this section or referred to it by the Board and for this purpose, shall have full access to information contained in the records of the company and external professional advice, if necessary.
  - (8) The recommendations of the Audit Committee on any matter relating to financial management, including the audit report, shall be binding on the Board.
  - (9) If the Board does not accept the recommendations of the Audit Committee, it shall record the reasons therefore and communicate such reasons to the shareholders.

- (10) The chairman of the Audit Committee shall attend the annual general meetings of the company to provide any clarification on matters relating to audit.
  - (11) If a default is made in complying with the provisions of this section, the company, and every officer who is in default, shall be punishable with imprisonment for a term which may extend to one year, or with fine which may extend to fifty thousand rupees, or with both."
- (b) Environmental reporting is the term now commonly used to describe the disclosure by an entity of environmentally related data, verified (audited) or not, regarding environmental risks, environmental impacts, policies, strategies, targets, costs, liabilities or environmental performance to those who have an interest in such information as an aid to enabling/enriching their relationship with the reporting entity) via either
- (a) the annual report and accounts package;
  - (b) a stand-alone corporate environmental performance report (CER);
  - (c) a site-centered environmental statement; or
  - (d) some other medium (e.g. staff newsletter, video, CD ROM, internet site)

Different methodological approaches to environmental reporting have evolved, mainly because of local cultural/regulatory differences are as under:

**Compliance based reporting:** Reporting the level of compliance with external regulations and consent limits is a common feature of the environmental reports of heavily regulated utilities (water, electricity).

**Impact based performance reporting:** Most private sector companies that are not subject to specific consent requirements identify their key environment impacts and base their reporting around target setting and performance (over time) in achieving those targets.

**The Eco-balance approach:** Some companies (including many from Germany) construct a formal "eco-balance" (resource inputs vs. product and non-product output) from which they then derive performance indicators.

**The environmental burden approach (ICI0:** ICI (the UK chemicals manufacturer) has developed an externally focused reporting approach which quantifies the company's impact on 6 or 8 environmental quality measures.

Environmental audits are becoming increasingly common in certain industries. The term "environmental audit" has a wide variety of meanings. They can be performed by external or internal experts (sometimes including internal auditors), at the discretion of the entity's management. In practice, persons from various disciplines can qualify to perform "environmental audits". Often the work is performed by a multi-disciplinary team. Normally, "environmental audits" are performed at the request of management and are for internal use. They may address various subject matters, including site contamination, or compliance with environmental laws and regulations. However, an "environmental audit" is not necessarily an equivalent to an audit of an environmental performance report.

16. (a) **Verification of Premiums Received:** (i) Vouch with copies of Insurance policies, Premium register, Cover notes of Premium receipts, the Policy register, Counterfoils of receipts etc. (ii) Calculation of premiums may be test checked by selecting policies at random. Under the Code of Conduct, premiums are payable in advance except where the insured maintains a deposit with Insurance company or furnishes a bank guarantee. (iii) If the premium amount are varied, the same should be verified by reference to endorsements made on the policies. The variations may be due to changes made in the conditions of policy. (iv) Premium received on re-insurance, should be verified with the related agreements.
- (b) **Claims Paid:** (i) Claims should be admitted only after a proper survey has been carried out. Payments should be made by crossed and order cheques. (ii) Claims are verified with claims register wherein all claims lodged with the insurance company are recorded. Claims outstanding but not paid should be provided for; even claims which have been intimated

should be taken into consideration. If certain claims are disputed, their liability may be computed on a reasonable basis. (iii) Payments on account of claims be computed on a reasonable basis. (iii) Payments on account of claims should be verified with payees, acknowledgements, discharge of liabilities signed by the claimants, other supporting evidence such as surveyor's report, repairers' bills, etc. (iv) Payments made under re-insurance contracts should be verified by reference to the agreement and the above points. (v) Claims amounts should be reduced by the value of property salvaged. This should be seen carefully.

- (c) Commission Paid and Received: (i) Payments of commission should be vouched with relevant vouchers and acknowledgements of agents. The amount should not exceed the maximum amount admissible for different classes of business. (ii) Commission received and paid under re-insurance contracts should be checked with re-insurance treaties, credit notes, bordereaux, receipts or other similar documentary evidence. (iii) A separate computation for commission should be made for re-insurance accepted and ceded for the purpose of separate disclosure in the accounts. It should be ensured that adequate provision is made for commission accrued but not paid.
  - (d) Balances outstanding against agents: (i) Verify that all these balances are fully recoverable and if recovery of any balance is doubtful, a provision is made there against. In the case of disputed amounts, a proper provision should be made since such balances are required to be shown in the balance sheet at amounts not exceeding their realisable values. (ii) Confirmation of agents' balances should be obtained directly from them and it should be seen that these have been recovered in succeeding period.
17. (a) Auditor's responsibilities regarding comparatives: AAS 25, "Comparatives", establishes standards on the auditor's responsibilities regarding comparatives.

The auditor responsibilities laid down are as under:

- (i) The auditor should determine whether the comparatives comply, in all material respects with the financial reporting framework relevant to the financial statements being audited. Further, the auditor should obtain sufficient appropriate audit evidence that the corresponding figures meet the requirements of the financial reporting framework.
- (ii) When the comparatives are presented as corresponding figures, the auditor's report should not specifically identify comparatives because the auditor's opinion is on the current period financial statements as a whole, including the corresponding figures.
- (iii) When the auditor's report on the prior period, as previously issued, included a qualified opinion, disclaimer of opinion, or adverse opinion and the matter which gave rise to the modification in the audit report is:
  - (a) unresolved and results in a modification of the auditor's report regarding the current period figures, the auditor's report should also be modified regarding the corresponding figures; or
  - (b) unresolved, but does not result in a modification of the auditor's report regarding the current period figures, the auditor's report should be modified regarding the corresponding figures.

In such circumstances, the auditor should examine that appropriate disclosures have been made or if appropriate disclosures have not been made, the auditor should issue a modification report on the current period financial modified with respect to the corresponding figures included therein.

- (iv) When the prior period financial statements are not audited, the incoming auditor should state in the auditor's report that the corresponding figures are unaudited.
- (b) Financial Indications and Going Concern: AAS-16 on "Going Concern", aims to establish standards on the auditor's responsibilities in the audit of financial statements regarding the



appropriateness of the going concern assumption as a basis for the preparation of the financial statements. The following are the financial indications be considered:

- ◆ Negative net worth or negative working capital.
- ◆ Fixed-term borrowings approaching maturity without realistic prospects or renewal or repayment, or excessive reliance on short-term borrowings to finance long-term assets.
- ◆ Adverse key financial ratios.
- ◆ Substantial operating losses.
- ◆ Substantial negative cash flows from operations.
- ◆ Arrears or discontinuance of dividends.
- ◆ Inability to pay creditors on due dates.
- ◆ Difficulty in complying with the terms of loan agreements.
- ◆ Change from credit to cash-on-delivery transactions with suppliers.
- ◆ Inability to obtain financing for essential new product development or other essential investments.
- ◆ Entering into a scheme of arrangement with creditors for reduction of liability.

(c) **Consolidated Financial Statements:** Consolidated financial statements are the financial statements of a group presented as those of a single enterprise. The consolidated financial statements provide the users of financial statements an overall picture of the holding company and its subsidiaries. Consolidated Profit and Loss Account gives the overall profitability of the group after adjustment of unrealised profit involved in mutual transactions and decomposition of profit of the subsidiaries into capital and revenue. Similarly, Consolidated Balance Sheet shows the unified state of affairs of the group after adjustment of mutual indebtedness and putting separately the minority interest. Thus the overall financial health of the holding company can be judged using Consolidated Financial Statements. Those who want to invest in the shares of the holding company or acquire it, need such consolidated statement for evaluation. Thus, in many developed countries like USA, UK Germany, France, etc. the consolidation of financial statements is compulsory. However, at present in India preparation of consolidated financial statements is not a legal necessity. However, Accounting Standard on Consolidated Financial Statements which came into force in respect of accounting periods commencing on or after 1<sup>st</sup> April, 2001 and will be mandatory in nature in case CFS Statements are to be prepared as per regulators' requirements or voluntary by an entity. The objective of this Statement is to require parent (also known as holding) enterprises to provide financial information about the economic activities of their groups by preparing consolidated financial statements. These statements are intended to present financial information about a parent enterprise and its subsidiary enterprises as a single economic entity to show the economic resources controlled by the group, the obligations of the group and results the group achieves with its resources. The proposed Accounting Standard lays down in detail the consolidation procedures and disclosure requirements.

(d) **Divisible Profits:** Divisible profits are profits available for distribution to shareholders as dividends. It is different from book profit or economist's concept of profit. It represents those profits which are legally available for distribution as dividends. In the earlier years there were disputes whether depreciation should be provided before declaration of dividend or not; there were disputes whether capital profits or profits on revaluation of assets are available for distribution. Now these controversies stand resolved through the provisions of Companies Act, 1956 and also the judicial pronouncements over the years.

Section 205 prohibits a company from declaring dividends out of its profits before providing for depreciation in the manner laid down in the section. Depreciation should be provided as per rates/methods prescribed in Schedule XIV of the Act; not only the year for which

dividend is declared but also in respect of preceding financial year or years [since the commencement of Companies (Amendment) Act, 1960] for which adequate depreciation had not been provided in the books. If a loss has been incurred in the past which remains debited in the accounts then the amount of loss or the amount of depreciation whichever is less should be provided in the books before any dividend is declared.

Under section 205(2A), the central government has the power to make rules regarding transfer of profits by a company to its reserves before any dividend can be declared.

Dividends may be declared out of the profits of the company for the current year after providing for depreciation. However, a company is required to transfer a prescribed percentage of its profits to reserves before declaring dividends. According to the rules framed by the central government in this regard, no dividend can be declared or paid by a company for any financial year out of its profits for that year unless it transfers a percentage of its profits for that year to reserve.

The second source of dividends are the reserves created out of the undistributed profits of any previous financial years after providing for depreciation. Section 205A(3) of the Act provides that dividends can be declared out of the reserves only in accordance with the rules framed by the central government in this behalf. A declaration which is not in accordance with such rules can be made only with the previous approval of the central government.

A company can also declare dividends out of the moneys provided by the central government or a state government for payment of such dividend in pursuance of a guarantee given by that government.

An auditor should be fully acquainted with all legal implications of dividends. Not only should he take into account the provisions of the Companies Act (specially sections 205-208), but he should also consider the contractual and other legal obligations which determine the divisibility of profits. It cannot be over-emphasised that a dividend beyond what is legally permissible can give rise to legal action, since it would be construed as a payment out of capital. Hence, the first task of the auditor is to ensure that the dividends payable are within the legally permissible limits.

In ascertaining divisible profits, in the following circumstances, capital profits are included provided:

- (i) the capital profits remain after a revaluation of all assets and liabilities;
- (ii) the capital profit is realised in cash; and
- (iii) the articles of association permits of such distribution.

- (e) **Suspension of Capitalisation of Borrowing Costs:** The expression 'reserve' has been defined in Part III of Schedule VI to the Act as not including "any amount written off or retained by way of providing for depreciation, renewals or diminution in the value of assets or retained by way of providing for any known liability". A reserve may be 'capital reserve' or 'revenue reserve'. The term "capital reserve" has not been defined in the Companies Act, 1956 except in a negative way in Part-III of Schedule VI to the Act. The expression "capital reserve" shall not include any amount regarded as free for distribution as dividend through the Profit and Loss Account. Capital reserve is created out of profits of a capital nature. Premiums issued on the issue of shares and debentures, profit made on redemption of debentures and the balance standing to the credit of forfeited shares account after re-issue of forfeited shares are some of the examples of capital reserve. In fact, capital reserves are in the nature of capital receipts which also cannot be distributed as dividends at all. AS-12, "Accounting for Government Grants" provides that where the grant relates to a non-depreciable asset, e.g., freehold land, and it has been decided that gross value of fixed asset should not be touched it should be generally be credited to capital reserve.

18. Adequate amount of working capital for the smooth running of the concern should have sufficient working capital but it should not allow the working capital to remain idle unduly. If a company can manage the working capital efficiently, there will be neither liquidity problem nor will there remain

idle fund. Keeping this significant factor in view and to ensure an adequate flow of working capital to the concern, the following action plan may be considered.

1. Preparation of budget in respect of sales, production, expenses, capital expenditure, working capital and ultimately a Master Budget consisting of projected Profit and Loss, Balance Sheet and Funds Flow Statements to estimate the requirement of working capital well in time.
2. Preparing the cash budget on month to month basis showing inflow and outflow of cash and the financing of the shortfall either by way of bank borrowing or from other financial institutions pending approval of the increased limit and release of funds by the banker. In case, there is a shortfall or an excess accumulation of fund over the budget due to unforeseen circumstances coupled with imbalance in inventory holding for reasons beyond control or the working capital position is disturbed in inventory holding for reasons beyond control or the working capital position is disturbed by some extraneous factors such as unusual delay in approval of supplies by the purchasing company, strike in transportation agencies, shortage of wagon delay in realisation of payments from customers, ad-hoc allotment of controlled items, then financial support from some other sources is essential so as to maintain the growth and activity in terms of the budgeted targets.
3. Being an engineering industry, the base raw materials like steel whose supplies may not be regular and not in uniform order. Therefore, in all such cases inventories should be classified properly to determine the level of stock of materials. The control over inventory where possible should strictly be maintained as sometimes it is noticed the holding of inventory generally goes up due to mismatch between supplies of materials and unplanned allotment of controlled materials.
4. Minimum work in progress should be maintained and for the purpose it is necessary to ensure that no bottlenecks develop at any stage during the production process.
5. The management must decide the optimum credit period which may really be the period in which the customers of the concern are able to dispose of the goods and realise the proceeds.
6. To obtain timely support from banks, a good amount of preplanning and follow-up action is necessary. Returns should be submitted in time so that review of the case may be made within least possible time and the cash credit requirements be finalised and sanctioned within the minimum loss of time.
7. In respect of collections, which can be improved by taking up proper follow up steps even where documents are presented through bank and waiting clearance. Where outstation cheques for large amounts are received against supplies the clearing of cheques take more than 25 to 30 days and instead if someone is deputed along with a letter of authority to the customer with a request to pay by bank demand draft at the cost of the company then the money can be realised within a week or so that any collection at the end may be credited to the deposit accounts for onward transmission to the main office.
8. Payment to creditors is another area which should be critically scrutinized to control over the average of the trade credit. Financial management is responsible for not only maintaining credit standing of the company but also for generating necessary credit financing. Purchase of raw materials should be arranged in sequence related to production requirements to avoid blockage of funds. Besides as stated above, scientific production planning and scheduling is absolutely necessary to reduce the conversion time and to minimise blockage of inventory by way of semi-finished goods.

## Appendices

*Appendix I – Text of Companies (Auditor's Report) Order, 2003*

*Appendix II – Announcement : Website*

*Appendix III – For Attention of Members in Part-time Practice*

*Appendix IV – Certification on Acting as Recovery Consultant in Banking Sector*

*Appendix V – General Clarification on AAS 9*

*Appendix VI – General Clarification on AAS 16*

*Appendix VII – General Clarification on AAS 26*

*Appendix VIII – Guidance Note on Independence of Auditor*

## Appendix I

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

*{after incorporating the amendments made by the Companies (Auditor's Report) (Amendment) Order, 2004<sup>1</sup> dated 25<sup>th</sup> November, 2004}*

Short title, application and commencement.

- (1) This order may be called the Companies (Auditor's Report) Order, 2003.
  - (2) It shall apply to every company including a foreign company as defined in section 591 of the Act, except the following:
    - (i) a Banking company as defined in clause (c) of section 5 of the Banking Regulation Act, 1949 (10 of 1949);
    - (ii) an insurance company as defined in clause (21) of section 2 of the Act;
    - (iii) a company licensed to operate under section 25 of the Act; and
    - (iv) a private limited company with a paid up capital and reserves not more than rupees fifty lakh and which does not have loan outstanding exceeding rupees twenty five lakh from any bank or financial institution and does not have a turnover exceeding rupees five crore at any point of time during the financial year.
  - (3) It shall come into force on the 1<sup>st</sup> day of July, 2003.
2. Definitions – In this Order, unless the context otherwise requires, -
- (a) "Act" means the Companies Act, 1956 (1 of 1956);
  - (b) "*chit fund company*", "*nidhi company*" or "*mutual benefit company*" means a company engaged in the business of managing, conducting or supervising as a foreman or agent of any transaction or arrangement by which it enters into an agreement with a number of subscribers that every one of them shall subscribe to a certain sum of instalments for a definite period and that each subscriber, in his turn, as determined by lot or by auction or by tender or in such other manner as may be provided for in the agreement, shall be entitled to a prize amount, and includes companies whose principal business is accepting fixed deposits from, and lending money to, members;
3. Auditor's report to contain matters specified in paragraphs 4 and 5. – Every report made by the auditor under section 227 of Act, on the accounts of every company examined by him to which this Order applies for every financial year ending on any day on or after the commencement of this Order, shall contain the matters specified in paragraphs 4 and 5.
4. Matters to be included in the auditor's report. – The auditor's report on the account of a company to which this Order applies shall include a statement on the following matters, namely :-

<sup>1</sup> DCA's notification number GSR/766(E).

- (i) (a) whether the company is maintaining proper records showing full particulars, including quantitative details and situation of fixed assets;  
(b) whether these fixed assets have been physically verified by the management at reasonable intervals; whether any material discrepancies were noticed on such verification and if so, whether the same have been properly dealt with in the books of account;  
(c) if a substantial part of fixed assets have been disposed off during the year, whether it has affected the going concern;
- (ii) (a) whether physical verification of inventory has been conducted at reasonable intervals by the management;  
(b) are the procedures of physical verification of inventory followed by the management reasonable and adequate in relation to the size of the company and the nature of its business. If not, the inadequacies in such procedures should be reported;  
(c) whether the company is maintaining proper records of inventory and whether any material discrepancies were noticed on physical verification and if so, whether the same have been properly dealt with in the books of account;
- (iii) (a) has the company granted any loans, secured or unsecured to companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and amount involved in the transactions; and  
(b) whether the rate of interest and other terms and conditions of loans given by the company, secured or unsecured, are prima facie prejudicial to the interest of the company; and  
(c) whether receipt of the principal amount and interest are also regular; and  
(d) if overdue amount is more than rupees one lakh, whether reasonable steps have been taken by the company for recovery of the principal and interest;  
(e) has the company taken any loans, secured or unsecured from companies, firms or other parties covered in the register maintained under section 301 of the Act. If so, give the number of parties and the amount involved in the transactions; and  
(f) whether the rate of interest and other terms and conditions of loans taken by the company, secured or unsecured, are prima facie prejudicial to the interest of the company; and  
(g) whether payment of the principal amount and interest are also regular.
- (iv) is there an adequate internal control system commensurate with the size of the company and the nature of its business, for the purchase of inventory and fixed assets and for the sale of goods and services. Whether there is a continuing failure to correct major weaknesses in internal control system
- (v) (a) whether the particulars of contracts or arrangements referred to in section 301 of the Act have been entered in the register required to be maintained under that section; and  
(b) whether transactions made in pursuance of such contracts or arrangements have been made at prices which are reasonable having regard to the prevailing market prices at the relevant time;  
(This information is required only in case of transactions exceeding the value of five lakh rupees in respect of any party and in any one financial year).
- (vi) in case the company has accepted deposits from the public, whether the directives issued by the Reserve Bank of India and the provisions of sections 58A, 58AA or any other relevant provisions of the Act and the rules framed there under, where applicable, have been complied with. If not, the nature of contraventions should be stated; If an order has been passed by Company Law Board or National Company Law Tribunal or Reserve Bank of India or any Court or any other Tribunal whether the same has been complied with or not?

- (vii) in the case of listed companies and/or other companies having a paid-up capital and reserves exceeding Rs.50 lakhs as at the commencement of the financial year concerned, or having an average annual turnover exceeding five crore rupees for a period of three consecutive financial years immediately preceding the financial year concerned, whether the company has an internal audit system commensurate with its size and nature of its business;
- (viii) where maintenance of cost records has been prescribed by the Central Government under clause (d) of sub-section (1) of section 209 of the Act, whether such accounts and records have been made and maintained;
- (ix) (a) is the company regular in depositing undisputed statutory dues including Provident Fund, Investor Education and Protection Fund, Employees' State Insurance, Income-tax, Sales-tax, Wealth Tax, Service Tax, Custom Duty, Excise Duty, cess and any other statutory dues with the appropriate authorities and if not, the extent of the arrears of outstanding statutory dues as at the last day of the financial year concerned for a period of more than six months from the date they became payable, shall be indicated by the auditor.  
(b) in case dues of Income tax/ Sales tax /Wealth tax/ Service tax/ Custom duty/ Excise duty/ cess have not been deposited on account of any dispute, then the amounts involved and the forum where dispute is pending shall be mentioned.  
(A mere representation to the Department shall not constitute a dispute).
- (x) whether in case of a company which has been registered for a period not less than five years, its accumulated losses at the end of the financial year are not less than fifty per cent of its net worth and whether it has incurred cash losses in such financial year and in the immediately preceding financial year;
- (xi) whether the company has defaulted in repayment of dues to a financial institution or bank or debenture holders? If yes, the period and amount of default to be reported;
- (xii) whether adequate documents and records are maintained in cases where the company has granted loans and advances on the basis of security by way of pledge of shares, debentures and other securities; If not, the deficiencies to be pointed out.
- (xiii) whether the provisions of any special statute applicable to chit fund have been duly complied with? In respect of nidhi/ mutual benefit fund/societies;
  - (a) whether the net-owned funds to deposit liability ratio is more than 1:20 as on the date of balance sheet;
  - (b) whether the company has complied with the prudential norms on income recognition and provisioning against sub-standard/doubtful/loss assets;
  - (c) whether the company has adequate procedures for appraisal of credit proposals/requests, assessment of credit needs and repayment capacity of the borrower;
  - (d) whether the repayment schedule of various loans granted by the nidhi is based on the repayment capacity of the borrower;
- (xiv) if the company is dealing or trading in shares, securities, debentures and other investments, whether proper records have been maintained of the transactions and contracts and whether timely entries have been made therein; also whether the shares, securities, debentures and other investments have been held by the company, in its own name except to the extent of the exemption, if any, granted under section 49 of the Act;
- (xv) whether the company has given any guarantee for loans taken by others from bank or financial institutions, the terms and conditions whereof are prejudicial to the interest of the company;
- (xvi) whether term loans were applied for the purpose for which the loans were obtained;
- (xvii) whether the funds raised on short-term basis have been used for long term investment; If yes, the nature and amount is to be indicated;



- (xviii) whether the company has made any preferential allotment of shares to parties and companies covered in the Register maintained under section 301 of the Act and if so whether the price at which shares have been issued is prejudicial to the interest of the company;
- (xix) whether security or charge has been created in respect of debentures issued?
- (xx) whether the management has disclosed on the end use of money raised by public issues and the same has been verified;
- (xxi) whether any fraud on or by the company has been noticed or reported during the year; If yes, the nature and the amount involved is to be indicated.

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

## Appendix II

### Announcement : Website

The Council at its meeting held in January, 2001 approved the detailed guidelines for posting the particulars on Website by Chartered Accountants in practice and firm(s) of Chartered Accountants in practice. The guidelines are as under:

1. The Chartered Accountants and/or Chartered Accountants' Firms would be free to create their own Website subject to the overall guidelines laid down by the Council hereunder. The actual format of the Website is not being prescribed nor any standard format of the Website is being given to provide independence to the Members. There is no restriction on the colours which may be used in the Website.
2. Individual Members would also be permitted to have their Webpages in their trade name or individual name.
3. The Chartered Accountants and/or Chartered Accountants' Firms would ensure that their Websites are run on a "pull" model and not a "push" model of the technology to ensure that any person who wishes to locate the Chartered Accountants or Chartered Accountants' firms would only have access to the information and the information should be provided only on the basis of specific "pull" request.
4. The Chartered Accountants and/or Chartered Accountants' Firms should ensure that none of the information contained in the Website be circulated on their own or through E-mail or by any other mode or technique except on a specific "pull" request.
5. The Chartered Accountants would also not issue any circular or any other advertisement or any other material of any kind whatsoever by virtue of which they solicit people to visit their Website. The Chartered Accountants would, however, be permitted to mention their Website address on their professional stationery.
6. The following information may be allowed to be displayed on the Firms'/Members' Websites:
  - (i) Member/Trade/Firm name.
  - (ii) Year of establishment.
  - (iii) Member/Firm's Address (both Head Office and Branches)
    - Tel. No(s)
    - Fax No(s)
    - E-mail ID(s)
  - (iv) Nature of services rendered (to be displayable only on specific "pull" request)

(v) Partners

| Partners<br>Name | Year of<br>Qualification | Other<br>Qualification(s) | Tel. No. Res.,<br>Address | Off.,<br>Mobile, | Direct,<br>E-mail | Area of Experience<br>(to be displayable<br>only on specific "pull"<br>request) |
|------------------|--------------------------|---------------------------|---------------------------|------------------|-------------------|---------------------------------------------------------------------------------|
|------------------|--------------------------|---------------------------|---------------------------|------------------|-------------------|---------------------------------------------------------------------------------|

(vi) Details of Employees –

| Professional | Others | Name | Designation | Area of experience<br>(to be displayable<br>only on specific "pull"<br>request) |
|--------------|--------|------|-------------|---------------------------------------------------------------------------------|
|--------------|--------|------|-------------|---------------------------------------------------------------------------------|

(vii) Job vacancies for the Chartered Accountant/firm of Chartered Accountants (including articleship).

(viii) No. of articled clerks. (to be displayable only on specific "pull" request).

(ix) Nature of assignments handled (to be displayable only on specific "pull" request) Names of clients and fee charged cannot be given.

7. Since Chartered Accountants in practice/firms of Chartered Accountants are not permitted to use logo with effect from 1<sup>st</sup> July, 1998, they cannot use log on Website also.

8. No photographs of any sort are permitted.

9. The members may include articles, professional information, professional updation and other matters of larger importance or of professional interest.

10. The bulletin boards can be provided.

11. The chat rooms can be provided which permit chatting amongst members of the ICAI and between Firms and its clients. The confidentiality protocol would have to be observed.

12. The members/firms can provide on line advice to their clients who specifically request for the advice whether free of charge or on payment.

13. The listing on suitable search engine should be permitted. However, the field of search should be restricted only to the field of "Chartered Accountants" or "CA" or "Indian CA", "Indian CPA", "Indian Chartered Accountant" or any permutation or combination related thereto. The Websites would be subjected to the guidelines contained herein and normally would not be vetted by the Institute of Chartered Accountants of India (ICAI). ICAI at its sole discretion may vet any of the Websites created by its members or individual Chartered Accountant or firms of Chartered Accountants and would have powers to direct deletion of certain portions and/or issue specific directions. In addition, necessary action can be taken in accordance with the Chartered Accountants Act, 1949 and the Regulations framed thereunder, in case there is any violation of the above guidelines.

14. The details in the Website should be so designed that it does not amount to soliciting client or professional work or advertisement of professional attainments or services. In case any content or technical feature of Website is against the professional Code of Conduct and Ethics as well as the restrictions contained in the schedules to the Chartered Accountants Act, 1949 or against the guidelines or directions issued by the ICAI from time to time, appropriate action will be initiated by the ICAI in terms of its disciplinary mechanism either *suo motu* or on complaint as provided under the Chartered Accountants Act, 1949.

15. The Website should ensure adequate secrecy of the matters of the clients handled through Website.

16. A number of Chartered Accountants Societies or other bodies are creating data-bases of Chartered Accountants or Chartered Accountants' Firms and are offering listing to Chartered Accountants. Such listing would be permitted with or without payment. In case a Chartered

Accountant or Chartered Accountants' Firm is a member of a professional body or association or Chamber of Commerce and they offer listing to the members or firm, the same would be permitted.

17. The Institute of Chartered Accountants of India will regularly inform the aforesaid guidelines to the members and the Chartered Accountants' Firms to ensure the strict compliance of the guidelines. The guidelines may be revised from time to time.

18. No Advertisement in the nature of banner or any other nature will be permitted on the Website.

19. The Website should be befitting the profession of Chartered Accountants and should not contain any information or material which is unbecoming of a chartered accountant.

20. The Website may provide a link to the Website of ICAI, its Regional Councils and Branches and also to the Websites of Government/Government Departments/Regulatory Authorities. Except that neither link to nor information about any other Website is permitted.

21. The address of the Website can be different from the name of the firm. But it should not amount to soliciting clients or professional work or advertisement of professional attainments or services. The Website address should be as near as possible to the individual name/trade name, firm name of the Chartered Accountant in practice or firm of Chartered Accountants in practice. The Committee on Ethical Standards and Unjustified Removal of Auditors (CESURA) of ICAI will decide in case there is any difficulty.

22. The address of the Website should be intimated to the ICAI within 30 days.

23. The Website should mention the date upto which it is updated and the information should not be at material variance from the information as per the ICAI's records.

A number of non-Chartered Accountants' firms, corporates including banks, finance companies and newspapers have set up their own Websites providing advisory services on taxation and other areas where Chartered Accountants are rendering professional service. Some of such Websites may request Chartered Accountants or Chartered Accountants' firms to provide consultation and advice through their Websites. This would be permitted subject to the condition that on the Website, contact address of the Chartered Accountant concerned is not provided nor such Website will contain any material which advertises professional achievements or status of such Chartered Accountant except making a statement that they are Chartered Accountants. The name of Chartered Accountants' firm with suffix "Chartered Accountants" would not be permitted.

### Appendix III

#### For Attention of Members in Part-time Practice

The Council at its 242<sup>nd</sup> meeting held in May, 2004 passed the following resolution as a part of and in continuation of the existing resolution under Regulation 190A which appears as Appendix No.9 to the C.A. Regulations, 1988 (2002 edition).

"Further resolved that the general and specific permission granted by the Council is subject to the condition that:

- (i) any member engaged in any other business or occupation, in terms of general or specific permission granted shall not be entitled to perform any attest function. However, a member engaging in any of the following area(s), in terms of the specific or general permission so granted, shall be entitled to perform attest function:
  - (a) Authorship of books and articles.
  - (b) Holding of Life Insurance Agency License for the limited purpose of getting renewal commission.
  - (c) Attending classes and appearing for any examination.
  - (d) Holding of public elective offices such as M.P., M.L.A. and M.L.C.
  - (e) Honorary office leadership of charitable-educational or other non-commercial organisations.

- (f) Acting as Notary Public, Justice of the Peace, Special Executive Magistrate and the like.
- (g) Part-time tutorship under the coaching organisation of the Institute.
- (h) Valuation of papers, acting as paper-setter, head-examiner or a moderator, for any examination.
- (i) Editorship of professional journals.
- (j) Acting as Surveyor and Loss Assessor under the Insurance Act, 1938.
- (k) Acting as Recovery consultant in the Banking Sector.
- (l) Any coaching assignment organised by the Institute, its Regional Councils and Branches of Regional Councils.
- (m) Engagement as Lecturer in an University, affiliated college, educational institution, coaching organization, private tutorship, provided the direct teaching hours devoted to such activities taken together do not exceed 25 hours a week.
- (ii) A member who is not entitled to perform attest function shall not be entitled to train articled clerks.

#### Appendix IV

##### Clarification on Acting as Recovery Consultant in Banking Sector

The members of the profession have sought the Institute's view as to whether the Chartered Accountants in Practice acting as Recovery Consultant for recovery of Non-Performing Assets (NPA) of Banks under the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002 (SRFA&ESI) can charge fee on percentage basis as is permitted under Regulation 192 of the Chartered Accountants Regulations, 1988 for 'receiver' or 'liquidator'.

The Institute has examined the matter in detail and is of the view that Recovery Consultant cannot be equated with 'receiver' or 'liquidator' provided under Regulation 192 of the Chartered Accountants Regulations, 1988 and as such, the charging of fee by Recovery Consultant in Banking Sector on percentage basis is not permissible.

#### Appendix V

##### General Clarification : GC)-AASB/1/2002 on AAS 9

##### Auditing and Assurance Standard (AAS) 9, Using the Work of an Expert

*{The following is the General Clarification (GC)-AASB/1/2002 issued by the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India on Auditing and Assurance Standard (AAS) 9, "Using the Work of an Expert."}*

1. Paragraph 12 of AAS 9 provide as under:

"12. The appropriateness and reasonableness of assumptions and methods used and their application are the responsibility of the expert. The auditor does not have the same expertise and, therefore, cannot always challenge the expert's assumptions and methods. However, the auditor should obtain an understanding of those assumptions and methods to determine that they are reasonable based on the auditor's knowledge of the client's business and on the results of his audit procedures."

2. The auditor while verifying the accrued liability for retirement benefits or for Group Gratuity Schemes has to use the work of an another expert, i.e., actuary or the insurer itself. In such a case, the issue to be considered is whether it is sufficient for the auditor to rely on the certificate given by insurer or actuary without establishing the reasonableness of the assumptions made by the actuary or the insurer based on the auditor's knowledge of the client's business. It is clarified that the auditor should, while using the certificate issued by the actuary or the insurer, obtain an understanding of the methods used by the actuary or the insurer in determining the liability and should also judge the appropriateness and reasonableness of assumptions, for example, with regard to the following:

- (i) Rate of Return
- (ii) Number of Employees
- (iii) Retirement Age
- (iv) Salaries
- (v) Promotion Policies
- (vi) Age of Employees

#### Appendix VI

General Clarification : (GC)-AASB/3/2004 on AAS 16

Auditing and Assurance Standard (AAS) 16, Going Concern

*{The following is the General Clarification (GC)/AASB/3/2004 issued by the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India on Auditing and Assurance Standard (AAS) 16, 'Going Concern'.}*

1. The Companies (Amendment) Act, 2000 has mandated that every private company existing on 13th December 2000 with a paid-up capital of less than one lakh rupees, shall, within a period of two years from such commencement enhance its paid up capital to one lakh rupees. Similarly, every public company existing on 13th December 2000 with a paid-up capital of less than five lakh rupees, shall, within a period of two years from such commencement enhance its paid up capital to five lakh rupees. Where a private company or a public company fails to enhance the paid-up capital to the statutory minimum, as mentioned above, such company shall be deemed a defunct company within the meaning of section 560 of the Companies Act, 1956 and its name shall be struck off from the register by the Registrar.
2. Paragraphs 5 and 6 of Auditing and Assurance Standard (AAS) 16, Going Concern provide as follows:
  - "5. The auditor should consider the risk that the going concern assumption may no longer be appropriate.
  - 6. Indications of risk that continuance as a going concern may be questionable could come from the financial statements or from other sources."
3. Further, AAS 16 also mentions that non-compliance with capital or other statutory requirements could be an example of an indication of risk that the going concern assumption may no longer be appropriate.
4. If a company fails to enhance its paid-up capital up to the statutory minimum, such company shall be deemed a defunct company within the meaning of section 560 of the Companies Act, 1956 and therefore, its name shall be struck off from the register by the Registrar of Companies. However, such an entity may decide not to carry on business or may decide to carry on the business in some other form of organisation, e.g., partnership, etc. This situation gives rise to the risk that the going concern assumption may no longer be appropriate.
5. The auditor, in such a situation, performs the audit procedures as required by the Auditing and Assurance Standard (AAS) 16, Going Concern. Unless, the entity under audit demonstrates otherwise, the auditor should consider the going concern assumption as inappropriate and report in accordance with paragraph 18 of AAS 16.

#### Appendix VII

General Clarification : GC)-AASB/2/2004 on AAS 26

Auditing and Assurance Standard (AAS) 26, Terms of Audit Engagement

*{The following is the General Clarification (GC)/AASB/2/2004 issued by the Auditing and Assurance Standards Board of the Institute of Chartered Accountants of India on Auditing and Assurance Standard (AAS) 26, "Terms of Audit Engagement".}*

1. The Auditing and Assurance Standard (AAS) 26, Terms of Audit Engagement was issued with a view to establish standards on:
  - (a) agreeing the terms of the engagement with the client; and
  - (b) the auditor's response to a request by a client to change the terms of an engagement to one that provides a lower level of assurance.
2. A question that arises is whether it is necessary that the engagement letter issued by the auditor should be acknowledged by addressee and returned to the auditor to indicate that the client's understanding of the terms of the engagement is in accordance with the engagement letter issued by the auditor and to establish that the auditor has complied with the requirements of the Standard in so far as they are related to sending the audit engagement letter.
3. Paragraphs 2 through 4 of AAS 26 provide as follows:
  - "2. The auditor and the client should agree on the terms of the engagement. The agreed terms would need to be recorded in an audit engagement letter or other suitable form of contract.
  3. This AAS is intended to assist the auditor in the preparation of engagement letters relating to audits of financial statements. The Standard is also applicable to related services. When other services such as tax, accounting, or management consultancy and other services are to be provided, separate letters may be appropriate.
  4. Though the objective and scope of an audit and the auditor's obligations are, normally, laid down in the applicable statute or regulations and the pronouncements of the Institute of Chartered Accountants of India, the audit engagement letters would be informative for the clients."
4. From the above it is clear that the basic purpose of issuing an engagement letter is that the auditor and the client should agree on the terms of the engagement. The auditor and the client are normally considered to be agreeing on the terms of the engagement if the objective and scope of an audit and the auditor's obligations are laid down in the statute or regulations governing the engagement. Examples of such engagements include audit under section 227 of the Companies Act, 1956, audit of public sector banks, etc. In such cases, it is not necessary that the engagement letter sent by the auditor in accordance with paragraph 5 of AAS 26 is acknowledged by the addressee and returned to the auditor to establish that the client's understanding of the terms of the engagement is in accordance with the engagement letter issued by the auditor. It shall be sufficient compliance with the requirements related to sending the audit engagement letter, if an engagement letter is appropriately delivered to the client and the auditor retains the evidence for such delivery. In such cases, the audit engagement letters would be informative for the clients.
5. If, however, the client seeks any further explanations or clarification in regard to any terms, conditions or other contents of the engagement letter issued, it might indicate that there exists a difference in understanding of the terms of audit engagement either on the part of the client or on the part of the auditor. The auditor, in such cases, should take necessary steps to resolve the issues, for example by appropriately replying to the issues raised by the client. It is also desirable that the auditor documents the evidence indicating that the issues are settled and the client and auditor agree on the terms of the engagement.
6. There may be certain engagements where the objective and scope of the engagement and the auditor's obligations are not laid down in the applicable statute or regulations. In such situations, the auditor should request the client that a copy of the engagement letter be acknowledged by the addressee and returned to the auditor to establish:
  - (a) that the client's understanding of the arrangements for the engagement is in accordance with the engagement letter issued by the auditor; and
  - (b) that the auditor has complied with the requirements of the standard in so far as they are related to sending the audit engagement letter.



## Appendix VII

### Guidance Note on Independence of Auditors

The following is the text of the Guidance Note on Independence of Auditors issued by the Council of the Institute of Chartered Accountants of India.

#### 1. Introduction

1.1 This Guidance Note aims to clarify the meaning of independence while performing their duties as Auditors. Professional integrity and independence is an essential characteristic of all the professions but is more so in the case of accountancy profession. Independence implies that the judgement of a person is not subordinate to the wishes or direction of another person who might have engaged him, or to his own self-interest. This document shall provide guidance to members about the specific circumstances and relationships that may create threats to independence. The Guidance Note also provides safeguards that should be employed by the auditors to mitigate the risk arising from such circumstances and relationship leading to the threats to independence.

1.2 It is not possible to define "independence" precisely. Rules of professional conduct dealing with independence are framed primarily with a certain objective. The rules themselves cannot create or ensure the existence of independence. Independence is a condition of mind as well as personal character and should not be confused with the superficial and visible standards of independence which are sometimes imposed by law. These legal standards may be relaxed or strengthened but the quality of independence remains unaltered.

1.3 There are two interlinked perspectives of independence of auditors, one, independence of mind; and two, independence in appearance.

The Code of Ethics for Professional Accountants, issued by International Federation of Accountants (IFAC) defines the term 'Independence' as follows:

"Independence is:

- (a) Independence of mind – the state of mind that permits the provision of an opinion without being affected by influences that compromise professional judgment, allowing an individual to act with integrity, and exercise objectivity and professional skepticism; and
- (b) Independence in appearance – the avoidance of facts and circumstances that are so significant a reasonable and informed third party, having knowledge of all relevant information, including any safeguards applied, would reasonably conclude a firm's, or a member of the assurance team's, integrity, objectivity or professional skepticism had been compromised."

1.4 Independence of the auditor has not only to exist in fact, but also appear to so exist to all reasonable persons. The relationship between the auditor and his client should be such that firstly, he is himself satisfied about his independence and secondly, no unbiased person would be forced to the conclusion that, on an objective assessment of the circumstances, there is likely to be an abridgement of the auditors' independence.

1.5 In all phases of a Chartered Accountant's work, he is expected to be independent, but in particular in his work as auditor, independence has a special meaning and significance. Not only the client but also the stakeholders, prospective investors, bankers and government agencies rely upon the accounts of an enterprise when they are audited by a Chartered Accountant. As statutory auditor of a limited company, for example, the Chartered Accountant would cease to perform any useful function if the persons who rely upon the accounts of the company do not have any faith in the independence and integrity of the Chartered Accountant. In such cases he is expected to be objective in his approach, fearless, and capable of expressing an honest opinion based upon the performance of work such as his training and experience enables him to do so.

1.6 The objective of an audit of financial statements, prepared within a framework of recognized accounting policies and practices and relevant statutory requirements, if any, is to enable an auditor to express an opinion on such financial statements. The auditor's opinion helps determination of the true and fair view of the financial position and operating results of an enterprise. The user, however, should

not assume that the auditor's opinion is an assurance as to the future viability of the enterprise or the efficiency or effectiveness with which management has conducted the affairs of the enterprise.

1.7 The idea of independence is instilled in the minds of Chartered Accountants from the commencement of their training under articles or audit service. It has to be applied in their day-to-day work and their success is dependent entirely upon their integrity, competence and independence of approach.

1.8 Dependent as it is on the state of mind and character of a person, independence, is a very subjective matter. One person might be independent in a particular set of circumstances, while another person might feel he is not independent in similar circumstances. It is therefore the duty of every Chartered Accountant to determine for himself whether or not he can act independently in the given circumstances of a case and quite apart from legal rules, in no case to place himself in a position which would compromise his independence.

1.9 The auditor should be straightforward, honest and sincere in his approach to his professional work. He must be fair and must not allow prejudice or bias to override his objectivity. He should maintain an impartial attitude and both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity. This is not self evident in the exercise of the reporting function but also applies to all other professional work. In determining whether a member in practice is or is not seen to be free of any interest which is incompatible with objectivity, the criterion should be whether a reasonable person, having knowledge of relevant facts and taking into account the conduct of the member and the member's behaviour under the circumstances, could conclude that the member has placed himself in a position where his objectivity would or could be impaired.

1.10 While performing audit functions, maintaining quality control is the objectives of the quality control and policies to be adopted by an Auditor shall ordinarily incorporate the following:

- (a) Professional Requirements: Personnel in the firm are to adhere to the principles of Independence, Integrity, Objectivity, Confidentiality and Professional Behaviours.
- (b) Skills and Competence: The firm is to be staffed by personnel who have attained and maintained the Technical Standards and Professional Competence required to enable them to fulfill their responsibilities with Due Care.
- (c) Assignment: Audit work is to be assigned to personnel who have the degree of technical training and proficiency required in the circumstances.
- (d) Delegation: There is to be sufficient direction, supervision and review of work at all levels to provide reasonable assurance that the work performed meets appropriate standards of quality.
- (e) Consultation: Whenever necessary, consultation within or outside the firm is to occur with those who have appropriate expertise.
- (f) Acceptance and Retention of Clients: An evaluation of prospective clients and a review, on an ongoing basis, of existing clients is to be conducted. In making a decision to accept or retain a client, the firm's independence and ability to serve the client properly are to be considered.
- (g) Monitoring: The continued adequacy and operational effectiveness of quality control policies and procedures is to be monitored.

1.11 A member not in practice has a duty to be objective in carrying out his or her professional work whether or not the appearance of professional independence is attainable. Thus a member performing professional work must recognize the problems created by personal relationships or financial involvement, which by reason of their nature or degree might threaten his independence.

1.12 Standing alone, the word "Independence" may lead observers to suppose that a person exercising professional judgment ought to be free from all economic, financial and other relationships. This is impossible, as every member of society has relationships with others. Therefore, the significance of economic, financial and other relationships should also be evaluated in the light of what a reasonable and informed third party having knowledge of all relevant information would reasonably conclude to be unacceptable.

1.13 Many different circumstances, or combination of circumstances, may be relevant and accordingly it is impossible to define every situation that creates threats to independence and specify the appropriate mitigating action that should be taken. In addition, the nature of assurance engagements may differ and consequently different threats may exist, requiring the application of different safeguards. A conceptual framework that requires chartered accountants to identify, evaluate and address threats to independence, rather than merely comply with a set of specific rules in the public interest.

## 2. Threats to Independence

2.1 The Code of Ethics for Professional Accountants, prepared by the International Federation of Accountants (IFAC) identifies five types of threats. These are:

1. Self-interest threats, which occur when an auditing firm, its partner or associate could benefit from a financial interest in an audit client. Examples include (i) direct financial interest or materially significant indirect financial interest in a client, (ii) loan or guarantee to or from the concerned client, (iii) undue dependence on a client's fees and, hence, concerns about losing the engagement, (iv) close business relationship with an audit client, (v) potential employment with the client, and (vi) contingent fees for the audit engagement.
2. Self-review threats, which occur when during a review of any judgement or conclusion reached in a previous audit or non-audit engagement, or when a member of the audit team was previously a director or senior employee of the client. Instances where such threats come into play are (i) when an auditor having recently been a director or senior officer of the company, and (ii) when auditors perform services that are themselves subject matters of audit.
3. Advocacy threats, which occur when the auditor promotes, or is perceived to promote, a client's opinion to a point where people may believe that objectivity is getting compromised, e.g. when an auditor deals with shares or securities of the audited company, or becomes the client's advocate in litigation and third party disputes.
4. Familiarity threats are self-evident, and occur when auditors form relationships with the client where they end up being too sympathetic to the client's interests. This can occur in many ways: (i) close relative of the audit team working in a senior position in the client company, (ii) former partner of the audit firm being a director or senior employee of the client, (iii) long association between specific auditors and their specific client counterparts, and (iv) acceptance of significant gifts or hospitality from the client company, its directors or employees.
5. Intimidation threats, which occur when auditors are deterred from acting objectively with an adequate degree of professional skepticism. Basically, these could happen because of threat of replacement over disagreements with the application of accounting principles, or pressure to disproportionately reduce work in response to reduced audit fees.

## 3. Safeguards to Independence

3.1 The Chartered Accountant has a responsibility to remain independent by taking into account the context in which they practice, the threats to independence and the safeguards available to eliminate the threats.

3.2 To address the issue, Members are advised to apply the following guiding principles: -

- § For the public to have confidence in the quality of audit, it is essential that auditors should always be and appears to be independent of the entities that they are auditing.
- § In the case of audit, the key fundamental principles are integrity, objectivity and professional skepticism, which necessarily require the auditor to be independent.
- § Before taking on any work, an auditor must conscientiously consider whether it involves threats to his independence.
- § When such threats exist, the auditor should either desist from the task or, at the very least, put in place safeguards that eliminate them. All such safeguards measure needs to be recorded in a form that can serve as evidence of compliance with due process.

§ If the auditor is unable to fully implement credible and adequate safeguards, then he must not accept the work.

### 3.3 Provisions contained under the Companies Act, 1956

3.3.1 In order to ensure independence, the law has made certain provisions which either prohibit the appointment of a person as auditor in certain circumstances or place certain restrictions on his appointment as auditor or put third parties on guard against the possibility of an abridgement of independence by requiring certain disclosures to be made. These provisions are briefly outlined below:

3.3.2 Section 226 of the Companies Act, 1956 prohibits the appointment of a Chartered Accountant as auditor of a Company if he is:

- (i) an officer or employee of the Company;
- (ii) a partner of a person in the employment of an officer or of an employee of the Company;
- (iii) a person who is indebted to the company for an amount exceeding Rs. 1000;
- (iv) a person 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 Rs. 1000;
- (v) a person holding any security of that company.

3.3.3 A person who is disqualified from becoming auditor of any body corporate under the above rules is also disqualified from appointment as auditor of such body's subsidiary, co-subsiary or holding company.

3.3.4 Section 314 of the Companies Act, 1956 makes separate provision for the case where an auditor of a Company (whether public or private) is a relative of a director, or manager of a private company of which the director of the company is a director or member. In the case of such a person he may be appointed as auditor of a company only if such appointment is approved with the consent of the company in general meeting obtained by a special resolution.

3.3.5 It will be observed from the above that the Act has specifically provided for cases where the independence of an auditor may be affected by his connection with the company and prohibited or restricted him from acting as auditor under those circumstances.

3.3.6 A question often arises as to whether an indebtedness (as referred in para (iii) above) arises in cases where in accordance with the terms of his engagement by a client (e.g. resolution passed at the general meeting) the auditor recovers his fees on a progressive basis as and when a part of the work is done without waiting for the completion of the whole job. In these circumstances, where in accordance with such terms the auditor recovers his fees on a progressive basis he cannot be said to be indebted to the company at any stage.

3.3.7 A question of indebtedness may also be raised where an auditor of a company purchases goods or services from a company audited by him. In such a case, if the amount outstanding exceeds Rs. 1000/- irrespective of the nature of the purchase or period of credit allowed to other customers the provisions concerning disqualification of auditor as contained in Section 226 (3)(d) of the Companies Act, 1956 will be attracted.

3.3.8 Another question which arises for consideration is whether a partner is disqualified from appointment as auditor when the firm of which he is a partner is indebted to the company in excess of the limit prescribed and whether the firm is disqualified from appointment as auditor when a partner of the firm is indebted in excess of the prescribed limit. In both cases, the disqualification will apply, because when a firm is appointed as auditor, each partner is deemed to be so appointed and when a firm is indebted, each partner is deemed to be indebted.

3.3.9 There may also be situations in which, though the appointment is in the individual name of a partner, the work, is, in fact, carried out by the firm and the fees are credited to the account of the firm. In such situations, the firm will be deemed to be acting as auditor and the disqualification will be attracted.

*3.4 Provisions contained under the Chartered Accountants Act, 1949, Chartered Accountants Regulations, 1988 and under Code of Ethics to ensure Independence of Auditors*

3.4.1 Clause (10) of Part I of the First Schedule to the Chartered Accountants Act, 1949 prohibits acceptance of, what have been described as contingent fees, i.e., fees, which are either based on percentage of profits or otherwise dependent on the finding or the results of employment.

3.4.2 What distinguishes a profession from a business is that professional service is not rendered with the sole purpose of a profit motive. Personal gain is one but not the main or the only objective. Professional opinion, therefore, frowns upon methods where payment is made to depend on the basis of results. It is obvious that a person who is to receive payment in direct proportion to the benefit received by his client, may be tempted to exaggerate the advantage of his service or may adopt means which are not ethical. It will have the effect of undermining his integrity and impairing his independence. Therefore, the members are prohibited from charging or accepting any remuneration based on a percentage of the profits or on the happening of a particular contingency such as, the successful outcome of an appeal in revenue proceedings.

3.4.3 Professional services should not be offered or rendered under an arrangement whereby no fee will be charged unless a specified finding or result is obtained or where the fee is otherwise contingent upon the findings or results of such services. However, fee should not be regarded as being contingent if fixed by a Court or other public authority.

3.4.4 The Council of the Institute has framed Regulation 192 which exempts members from the operation of this Clause in certain professional services. The said Regulation 192 is reproduced below:

192. Restriction on fees

No chartered accountant in practice shall charge or offer to charge, accept or offer to accept, in respect of any professional work, fees which are based on a percentage of profits, or which are contingent upon the findings, or results of such work:

Provided that:

- (a) in the case of a receiver or a liquidator, the fees may be based on a percentage of the realisation or disbursement of the assets;
- (b) in the case of an auditor of a co-operative society, the fees may be based on a percentage of the paid up capital or the working capital or the gross or net income or profits; and
- (c) in the case of a valuer for the purposes of direct taxes and duties, the fees may be based on a percentage of the value of the property valued.

3.4.5 Attention of the members is invited to the provisions of Clause (4) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 which provides that a Chartered Accountant in practice shall be deemed to be guilty of professional misconduct if he expresses his opinion on financial statements of any business or any enterprise in which he, his firm or a partner in his firm has a substantial interest, unless he discloses his interest also in his report.

3.4.6 If the opinion of auditors are to command respect and the confidence of the public, it is essential that they must disclose every factor which is likely to affect their independence. Since financial interest in the business can be one of the important factors, which may disturb independence, the clause provides that the existence of such an interest direct or indirect should be disclosed. This is intended to assure the public as regards the faith and confidences that could be reposed on the independent opinion expressed by the auditors.

3.4.7 The words "financial statements" used in this clause would cover both reports and certificates usually given after an examination of the accounts or the financial statement or any attest function under any statutory enactment or for purposes of income-tax assessments. This would not however, apply to cases where such statements are prepared by members in employment purely for the information of their respective employers in the normal course of their duties and not meant to be submitted to any outside authority.



3.4.8 Public conscience is expected to be ahead of the law. Members, therefore, are expected to interpret the requirement as regards independence much more strictly than what the law requires and should not place themselves in positions which would either compromise or jeopardise their independence.

3.4.9A Member must take care to see that he does not get into situations where there could be a conflict of interest and duty. For example, where a Chartered Accountant is appointed the liquidator of a company, he should not himself audit the Statement of Account to be filed under Section 551 (1) of the Companies Act, 1956. The audit in such circumstances should be done by a Chartered Accountant other than the one who is the liquidator of the company. Attention of the members is drawn to the audit assignments where appointment is done by the Comptroller & Auditor General of India (C&AG), Reserve Bank of India (RBI) and such other authorities. In addition to ensuring independence during the assignment, it is also essential to avoid any situation in near future which may be interpreted as a threat to independence, as for example, he or any other partner of his firm should not accept any other assignment such as internal audit, system audit and management consultancy services within one year from the completion of audit assignment.

3.4.10 A Chartered Accountant in employment should not certify the financial statements of the concern in which he is employed, or of a concern under the same management as the concern in which he is employed, even though he holds certificate of practice and that such certification can be done by any chartered accountant in practice. This restriction would not however apply where the certification is permitted by any law, e.g. Section 228 (iv) of the Companies Act, 1956 and the Companies (Branch Audit Exemption) Rules made thereunder. The Council has decided that a chartered accountant should not by himself or in his firm name:-

- (i) accept the auditorship of a college, if he is working as a part-time lecturer in the college.
- (ii) accept the auditorship of a trust where his partner is either an employee or a trustee of the trust.

3.4.11 Many new areas of professional work have been added, e.g., Special Audit under the Statutes, Tax Audit, Concurrent Audit of Banks, Concurrent Audit of Borrowers of Financial institutions, Audit of non-corporate borrowers of banks and financial institutions, audit of stock exchange, brokers etc. The Council wishes to emphasize that the requirement of Clause (4) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 is equally applicable while performing all types of attest functions by the members.

3.4.12 Some of the situations which may arise in the applicability of Clause (4) of Part I of the Second Schedule to the Chartered Accountants Act, 1949 are discussed below for the guidance of members:-

1. Where the member, his firm or his partner or his relative has substantial interest in the business or enterprise.

The independence of mind is a fundamental concept of audit and/or expression of opinion on the financial statements in any form and, therefore, must always be maintained. Nothing can substitute for the essential and fundamental requirements of independence. Therefore, the Council's views are clarified in the following circumstances.

- (i) An enterprise/concern of which a member is either an owner or a partner

The holding of interest in the business or enterprise by a member himself whether as sole-proprietor or partner in a firm, in the opinion of the Council, would affect his independence of mind in the performance of professional duties in conducting the audit and/or expressing an opinion on financial statements of such enterprise. Therefore, a member should not audit financial statements of such business or enterprise.

- (ii) Where the partner or relative of a member has substantial interest

The holding of substantial interest by the partner or relative of the member in the business or enterprise of which the audit is to be carried out and opinion is to be expressed on the financial statement, may also affect the independence of mind of the member, in the opinion of Council, in the performance of professional duties. Therefore, the member may, for the same reasons as not to compromise his independence, desist from undertaking the audit of



financial statements of such business or enterprise. However, where a member undertakes the audit of such business or enterprise, he should disclose such interest in his report while expressing his opinion on the financial statements of such business or enterprise.

2. Where the member or his partner or relative is a director or in the employment of an officer or an employee of the company

Section 226 of the Companies Act, 1956 specifically prohibits a member from auditing the accounts of a company in which he is a director or in the employment of an officer or an employee of the company. Although the provisions of the aforesaid section are not specifically applicable in the context of audits performed under other statutes, e.g. tax audit, yet the underlying principle of independence of mind is equally applicable in those situations also. Therefore, the Council's views are clarified in the following situations.

- (i) Where a member is a director

In cases where the member is a director of a company the financial statements of which are to be audited and/or opinion is to be expressed, he should not undertake such job and/or express opinion on the financial statements of that company.

- (ii) Where a partner or relative of the member is a director in the company who has a substantial interest.

In such cases for the reason as not to compromise with the independence of mind, the member may desist from undertaking the audit of financial statements and/or expression of opinion thereon. However, if a member feels that his independence is not affected and undertakes the audit of such company, he should disclose such interest in his report while expressing his opinion on the financial statements of such company.

The meaning of the words "relative" and "substantial interest" shall be the same as are contained in the Resolution passed by the Council in pursuance to Regulation 190A of Chartered Accountants Regulations, 1988 (Appendix 9 of 2002 edition).

3.4.13 An accountant is expected to be no less independent in the discharge of his duties as a tax consultant or as a financial adviser than as auditor. In fact, it is necessary that he should bear the same degree of integrity and independence of mind in all spheres of his work. Unless this is done, the accounts of companies audited by Chartered Accountants or statements made by them during the course of assessment proceedings would not be relied upon as correct by the authorities.

3.4.14 The Members are not permitted to write the books of accounts of their auditee clients.

3.4.15 A statutory auditor of a company cannot also be its internal auditor, as it will not be possible for him to give independent and objective report issued under sub-Section 4A of Section 227 of the Companies Act, 1956 read with the Companies (Auditors' Report) Order, 2003.

3.4.16 The Council has issued a Notification No.1-CA(37)/70 dated 23rd May, 1970 whereby a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if—

- I. he accepts appointment as Cost auditor of Company under Section 233B of the Companies Act, 1956 while he -
  - (a) is an auditor of the company appointed under Section 224 of the Companies Act; or
  - (b) is an officer or employee of the company; or
  - (c) is a partner, or is in the employment of an officer or employee of the company; or
  - (d) is a partner or is in the employment of the Company's auditor appointed under Section 224 of the Companies Act, 1956; or
  - (e) is indebted to the company for an amount exceeding one thousand rupees, or 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

II. after his appointment as Cost Auditor, he becomes subject to any of the disabilities stated in items I (a) to (e) above and continues to function as a cost auditor thereafter.

3.4.17 The Council has issued a Notification No.1-CA(39)/70 dated 16th October, 1970 whereby a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he accepts the appointment as auditor of a company under Section 224 of the Companies Act, 1956, while he is an employee of the cost auditor of the Company appointed under Section 233B of the Companies Act, 1956.

3.4.18 The Council has issued a Notification No.1-CA(7)/60/2002 dated 8th March, 2002 whereby a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he accepts the appointment as statutory auditor of Public Sector Undertaking(s)/ Government Company(ies)/Listed Company(ies) and other Public Company(ies) having turnover of Rs. 50 crores or more in a year and accepts any other work(s) or assignment(s) or service(s) in regard to the same Undertaking(s)/ Company(ies) on a remuneration which in total exceeds the fee payable for carrying out the statutory audit of the same Undertaking/company.

3.4.19 The Council has issued a Notification No.1-CA(7)/63/2002 dated 2nd August, 2002 whereby a member of the Institute in practice shall be deemed to be guilty of professional misconduct, if he accepts appointment as auditor of a concern while he is indebted to the concern or has given any guarantee or provided any security in connection with the indebtedness of any third person to the concern, for limits fixed in the statute and in other cases for amount exceeding Rs. 10,000/-.

3.4.20 To ensure that the professional independence of a member doing attest function does not appear to be jeopardized he should, as far as possible, take care to see that the professional fees for audit and other services received by the firm in which he is a partner, by him and his partners individually and by firm or firms in which he or his partner are partners from one or more clients or companies under the same management does not exceed 40% of the gross annual fees of the firm, firms and partners referred to above. 'Companies under the same management' here would refer to the definition of this expression as provided in section 370(1-B) of the Companies Act, 1956.

Provided that no such ceiling on the gross annual professional fees of a member would be applicable where such fees do not exceed two lakhs of rupees in respect of a member or firm including fees received by the member or firm for other services rendered through the medium of a different firm or firms in which such member or firm may be a partner or proprietor.

Provided further that no such ceiling on the gross annual professional fees of a member would be applicable in the case of audit of government companies, public undertakings, nationalized banks, public financial institutions or where appointments of auditors are made by the Government.

3.4.21 Members' attention is also drawn to Clauses (8) & (9) of Part I of the First Schedule to the Chartered Accountants Act, 1949: -

"A Member shall be deemed to be guilty of professional misconduct, if he:

X    XX    XXX    XXXX

(8) accepts a position as auditor previously held by another chartered accountant or a restricted state auditor without first communicating with him in writing;

(9) accepts an appointment as auditor of a company without first ascertaining from it whether the requirements of Section 225 of the Companies Act, 1956 in respect of such appointment have been duly complied with."

3.4.22 Clause (8) of Part I of First Schedule to the Chartered Accountants Act, 1949 emphasized the requirement of mandatory communication with the previous auditor in all types of audit viz., statutory audit, tax audit, internal audit, concurrent audit or any kind of audit and it is equally applicable to audits of both government and non-government entities.

3.4.23 Clause (9) of Part I of First Schedule to the Chartered Accountants Act, 1949 provided that an auditor of the company before accepting the appointment, should ascertain from the auditor whether the requirements of Section 225 of the Companies Act, 1956 in respect of such appointment have been duly complied with. Section 224 of the Companies Act, 1956 contains several provisions in the matter

of appointment of auditors in different circumstances and situations whereas Section 225 laid down the procedure which must be followed whenever a company desires to change its auditor. Also that the validity of the appointment of an auditor is not challenged or objected to by shareholders or the retiring auditors at a later date, it has been made obligatory to ascertain from the company that the appropriate procedure in the matter of appointment has been faithfully followed. Independence of auditor is a concept to be addressed through its all the possible aspects and the message of Clause (8) & (9) is to ensure that an auditor should be conscious about this aspect from the very point of accepting the position of an auditor.

#### 4. Conclusion

4.1 The Council feels that there are adequate safeguards provided in the Companies Act, 1956 as well as in the Chartered Accountants Act, 1949. The Council is of the view that independence, being a state of the mind, is not necessarily affected by the fact of mere relationship any more than it should be existence if the relationship did not exist. In any case, lest there may be any feeling in the public mind that relationship would affect the independence of auditors, the Council suggests that where, due to near relationship of an auditor, with a Managing or a Whole-Time Director the independence of an auditor is likely to be jeopardized, he should use his good sense, and acting in the best traditions of the profession, refrain from accepting the appointment.

4.2 If the opinion of chartered accountant is to command respect and the confidence of the public, it is essential that they must ensure their independence to assure the public as regards the faith and confidence that could be reposed on them. The Chartered Accountant should ensure his independence in all assurance services including concurrent audit, tax audit and internal audit. The chartered accountant should make it certain that his independence is not jeopardized. Where he feels that his independence is jeopardized, he should refrain from accepting the assignment.